

**THE MICROFINANCE MARVEL:
WHERE DOES HOPE MEET REALITY?**

BY

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ABSTRACT

There is an immense worldwide focus on microfinance as a means to abate poverty. What began as small loans provided to microentrepreneurs for business purposes has come to include consumer loans and other financial services for the poor, provided in an increasingly commercial environment. Microfinance has experienced rapid growth and created high expectations due to its perceived ability to produce economic benefits and lead to improvements in areas like gender relations and health and education. Microcredit has been especially useful for vulnerable, self-employed individuals working in the informal economy.

However, microfinance is not an effective tool to spur economic growth on a national or even regional level, and cannot live up to the hopes it has produced. This thesis will look at important concerns and limitations related to what has become a global microfinance movement. The analysis is influenced by experiences as an intern in Paraguay with Fundación Paraguaya, a development organization that offers group and individual microloans.

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questions, and enabled me to get a true sense of how microfinance works. I would also like to express my admiration for those who run microenterprises in Paraguay, and throughout the developing world, for their dedication to their families and drive to survive, even when so many factors are working against them.

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INTRODUCTION

Throughout modern history, attention to the goal of leveling the global playing field, and the means with which it may be achieved, has gone through profound changes. In the League of Nation's World Economic Surveys in 1938, mention of the underdeveloped world was almost entirely excluded; the report included only one paragraph on South America and the poor areas in Asia and Africa were entirely overlooked (Arndt 33).

After World War II and the success of the Marshall Plan, people began to realize that the improvement of well-being for people around the world could be achieved through human intervention. In the years since, development practitioners have been chasing what development economist William Easterly aptly referred to as the “elusive elixir,” or “lurking panacea”: the key to the type of sustainable economic and social development that will effectively eliminate poverty from the globe. Today, progress towards this goal is being pursued by individuals, governments, philanthropists, colossal international organizations such as the World Bank, and tens of thousands of non-governmental organizations (NGOs).

Despite decades of effort, very few “developing” nations made the transition to “developed” status in the twentieth century; most of the same groups that lived below the poverty line generations ago have yet to transcend that marker. Currently, about 80 percent of the world's population lives in developing

countries (Stiglitz, Making Globalization Work 26). The “lurking panaceas” for which economists have continually searched have often been too thinly framed within the field of economics, based upon unproven or even disproven theory and ideology. Repeatedly, the most widely implemented development strategies have been the result of popular economic thinking of the time, with swaths of policies following trends based on the same platitudes.

Nobel laureate Amartya Sen stated that, in the field of economic development, “Yesterday's unexamined faith has become today's heresy, and yesterday's heresy is now the new superstition” (Sen 111). Easterly quipped, “...just as various claims to have found the elixir of life proved groundless, we economists have too often peddled formulas that violated the basic principle of economics.” He goes on to say that the “elusive quest for growth” remains elusive, and if economists’ quests to discover the means by which poor countries could become rich were successful, “it would be one of humankind’s great intellectual triumphs” (Easterly, *The Elusive Quest* xii, xi). Development expert Jeffrey Sachs writes that, “Development economics needs an overhaul in order to be much more like modern medicine, a profession of rigor, insight, and practicality” (Sachs 74).

For many years state-led, top-down development policies were the fashion, which meant large-scale industrialization and the concentration of economic power in the hands of a few. These trends were often reinforced by the

international aid community that poured billions of dollars into numerous, and often dubious, large-scale development projects (Woller and Woodworth 268). The failure of many of these various macro-level strategies to live up to their promise of prosperity, due to variegated reasons, including the inefficacy of “trickle-down economics” and the failure of the “invisible hand,”¹ has led to a rethinking of development strategies in recent years.

After generations of disappointment, many lessons have been learned and mindsets have changed. National and local policies designed and implemented from the bottom up are gaining ground against the top-down paradigm of the past. Not only have the policies to counter poverty changed, but so has the very definition of the problem. A plethora of additional indicators have been incorporated into the definitions of poverty, broadening the concept while specifying its meaning.²

Led by brilliant minds like Sen, Joseph Stiglitz, and Mohammad Yunus, even some of the economists and institutions considered by some to be obdurate and tethered to dogma have made great strides refashioning traditional approaches. For example, in the 1990s the United Nations (UN) partnered with

¹ The term “invisible hand” was first coined by Adam Smith in The Theory of Moral Sentiments and was used in his other works, including “the Bible of economics,” The Wealth of Nations. It is a term used to describe the self-regulating nature of the marketplace, in which the forces of self-interest, competition, and supply and demand allocate resources. This is the core principle of laissez-faire economics. Many criticize the way the philosophy has been used; Stiglitz has said “the reason that the invisible hand seems invisible is that it is not there” (Stiglitz, *Making Globalization Work* xiv).

² One World Bank study mentioned 33 different poverty lines developed and used by particular countries in addressing the needs of their poor (Yunus, *Banker to the Poor* 19).

Sen to develop the Human Development Index (HDI), which has been widely implemented for use as a more accurate measure of wellbeing than traditional indicators such as Gross Domestic Product (GDP). Instead of solely relying on economic factors, the HDI uses a more encompassing measurement of wellbeing, looking at life expectancy at birth, education (literacy and school enrollment), and GDP per capita.³

The Millenium Development Goals (MDGs) represent the world's most important commitment to improving wellbeing to date. These goals, which are meant to be achieved by 2015, were officially established at the Millenium Summit in 2000 and agreed upon by the 192 UN member states and more than twenty international organizations.⁴ The eight overall goals are: to eradicate extreme poverty and hunger, achieve universal primary education, promote gender equality and empower women, reduce child mortality, improve maternal health, combat HIV/AIDS, malaria and other diseases, ensure environmental sustainability, and develop a global partnership for development (UNDP).⁵

³ It should be noted that HDI has been criticized for reasons including a failure to take the political and civil spheres into account, not representing appropriate measures of inequality, redundancy, and being based upon a lack of quality data.

⁴ A commitment of 0.7 percent of Gross National Product (GNP) was supposed to have been established for each developed country to enact towards achieving these goals, yet many wealthy nations, including the U.S., have consistently fallen far short of this figure (this 0.7 percent commitment for Official Development Assistance (ODA) was first made in 1970 by the UN General Assembly). As of 2004 the U.S. spent thirty times more on defense than on foreign assistance (\$450 billion compared to \$15 billion (Sachs 329).

⁵ For a measure of how countries contribute to development, based upon seven policy indicators, see the Center for Global Development's Commitment to Development Index (CDI) (<http://www.cgdev.org>).

Many of the strategies promoted to achieve these goals are being enacted on the “micro-level.” The most promising and attention-garnering of these emerging strategies, which has been credited by some experts as being an integral piece of the formula for achieving the MDGs, is “microfinance.” Initially, microfinance was a strategy that served to mitigate capital constraints faced by small entrepreneurs by providing small loans for business purposes, frequently in amounts of less than \$100. Often, additional services helpful to the poor, such as business training or health and education programs, are offered alongside financial services. While microfinance once referred only to these small “microloans” meant for entrepreneurs, in recent years microfinance has come to include a wide range of financial services offered on a “micro” scale, mainly to poor people who have historically been excluded from financial services. These include services such as business or consumer credit, savings, wire transfers (including for remittances), and insurance.

Rather than “trickling down” from the top through government policy or big business, microfinance has traditionally been carried out on a local level by NGOs, with the goal being to put the keys to economic empowerment in the hands of individuals. Microfinance has been a direct response to the failed top-down policies of the past, and some see it as shifting development responsibility from the public to the private sector. The popularity of microfinance is in part attributable to the fact that it appeals to those on all sides of the political spectrum. It falls within the scope of some left-leaning ideals because it targets the poor and

provides a perceptible amount of poverty alleviation through self-help, and until recently, did so without the influx of big business (especially in comparison with platforms like foreign direct investment (FDI)). Microfinance appeals to the right because it is associated with enabling entrepreneurship and business development so the poor can provide for themselves, without state intervention and handouts. More importantly, the concept of microfinance is meant to supersede years of frequently ineffective foreign aid.⁶ In effect, microfinance is seen as a sustainable tool for improving lives, and not just another handout.

With a few exceptions, most development initiatives have overlooked the fact that poor *individuals* have lacked access to even the most basic financial services such as credit and savings.⁷ This is evidenced by the fact that, as of 2005, fewer than 18 percent of the world's poorest households had access to financial services (Meehan 2).⁸ In Latin America, the vast majority of households lack access to formal credit or savings services, especially in rural areas, and even in relatively developed metropolitan areas.⁹ In 2004 the Consultative Group to

⁶ The West has spent \$2.3 trillion on foreign aid in the last fifty years (Easterly, *The White Man's Burden* 4).

⁷ Multiple government programs have provided credit to farmers, but most resulted in failure. The lack of success is sometimes attributed to the fact that, since the funds were distributed by the government, people treated it like an allowance and not a loan to be repaid.

⁸ In the developing world, there have been multiple reasons that access to credit has not been more widespread, and lack of demand usually is not cited as one of them. The impecunious have historically turned to family members, moneylenders (loan sharks), or other informal lenders for access to credit. These lenders are usually not regulated, which means penalties for non-repayment can sometimes include threats of violence, and exorbitant interest rates well over 100 percent can be the norm.

⁹ Eighty percent of households in Mexico City and 60 percent of households in urban Brazil are "financially excluded." Only about 13 percent of families in the U.S. and 7 percent in the U.K. lack bank accounts (Fay and Laderchi 209).

Assist the Poor (CGAP) estimated that, with a market supply in the \$4 billion range, less than 5 percent of the total demand for microfinance was being met (Meehan 1).¹⁰ In 2009, after tremendous growth, experts were putting this figure at about 10 percent (Hechler-Fayd'herbe 2).

In Sen's system of instrumental freedoms, availability and access to finance are core economic facilities (Sen 39). Likewise, access to credit is part of John Rawls' global justice framework (Rawls 42). Milton Friedman has been quoted as saying that "The poor stay poor not because they are lazy, but because they have no access to capital" (Kiplinger 62). Adam Smith's words from The Wealth of Nations, which is considered to be the founding work upon which the modern field of economics is based, sums up the philosophy behind microcredit: "Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little."

In addition to increases in household income and consumption, microfinance proponents have claimed that microfinance leads to a myriad of social and economic benefits, including enhancing business profits, nutrition, schooling, contraception, and a variety of measures of empowerment and changes in social consciousness, especially for women (Armendáriz and Morduch 200). Microcredit has even been used to counter human sex trafficking (Getu). According to the 2006 Microcredit Summit Campaign Report, microfinance can

¹⁰ It should be noted that these types of figures are widely contested. It is often assumed there is an effective demand in areas where no supply exists. Some observers argue that in certain areas, no supply exists because there is no demand (Dichter et al.).

produce a quadruple bottom line: relieving suffering, bringing dignity, becoming sustainable and inspiring supporters (Daley-Harris np).

In the past decade and a half, “microfinance,” tied in with other buzzwords like “grassroots,” “microenterprise,” “barefoot banking,” and “self-empowerment,” has quickly become the newest craze in development thinking. Its popularity comes in part because of its perceived sustainability and the fact that it represents a stark contrast to many of the traditional macroeconomic policies that rely on aid or economic doctrine to achieve their putative goal of helping the poor. With the explosive growth of what has become a global movement, microfinance institutions (MFIs) have multiplied rapidly and now operate in every major region of the world, from the most remote villages of Africa to the inner-cities of the United States.

Between December 1997 and December 2005, the number of MFIs reporting to the Microcredit Summit increased from 618 to 3,133,¹¹ while the number of people who received credit from these institutions rose from 13.5 to 113.3 million in the same short period (Daley-Harris np). In 2009 CGAP estimated that the microfinance industry had grown to the range of about \$30 billion, and expanded lending at an extraordinary pace of 40 to 50 percent annually from 2004 to 2009 (Copeland A12). Between 2004 and 2007, foreign

¹¹ The definition of an MFI can vary. CGAP estimates there are as many as 10,000 MFIs worldwide (though just 150-200 are estimated to be serving the vast majority of clients) (Callaghan, Gonzalez, Maurice, and Novak 117).

investment in MFIs in developing countries more than quadrupled to reach a total of US\$5.7 billion. There are now more than 100 investment funds specializing in microfinance, at least 53 of which have been established only since 2005 (PR Newswire np). These funds returned 4.47 percent in the twelve months leading up to August of 2009, compared to a 22 percent loss by Standard & Poor's 500-stock index (Copeland A12).

The surge of attention microfinance is receiving has come from both the public and private sectors. There has certainly been an efflorescence of academic literature devoted to microfinance, in addition to targeted interest from other increasingly diverse areas. In January of 1997 the UN created a plan to make \$21.6 billion available to 100 million of the world's poor through microfinance programs, and later declared 2005 to be the International Year of Microcredit (Egli 505).¹²

The year 2006 brought microfinance the greatest attention to date when the Nobel Prize was awarded to the most famous pioneers of the microfinance movement, Mohammad Yunus and the Grameen Bank. Since then, Yunus has been awarded the Presidential Medal of Freedom by Barack Obama and was named one of BusinessWeek's Thirty Greatest Entrepreneurs of All-time.¹³ He has also been featured on the popular television series The Simpsons, and even has a major motion picture of his life slated for production in 2010. Wealthy

¹² The International Year of Microcredit was co-sponsored by Citicorp.

¹³ Businessweek titled Yunus' article "Nobel Winner Yunus: Microcredit Missionary" (Gangemi).

philanthropists such as George Soros, eBay co-founder Pierre Omidyar, and foundations run by Bill Clinton and Bill and Melinda Gates have pledged hundreds of millions of dollars to microfinance. Further support comes from activist celebrities, just a few of which include Natalie Portman, Michael Douglas, Robert Duvall, and Yeardley Smith (the voice of Lisa from The Simpsons).

This phenomenal growth and enormous surge in attention certainly warrants close scrutiny, as it is apparent that development practitioners are caught up in this latest trend, just as in the past. As pointed out by one of the more outspoken skeptics of microfinance, Thomas Dichter, 55,000 staff days and \$30 million were spent on 120 microfinance conferences in 2005, many of them in celebration of microfinance as an accepted idea and an accomplished set of practices. Dichter stated that “Despite the fact that there continues to be some lively debates within the field, it is undeniable that a degree of self-satisfaction has set in” (Dichter and Harper, *What's Wrong with Microfinance?* 5).

Currently, the microfinance movement stands at a crossroads, and 2009 may turn out to be a “pivotal year” in regards to clearing up what the actual effects of microfinance really are (Roodman np). In addition to phenomenally rapid growth, the movement is experiencing a sea change. Microfinance services are increasingly being offered by commercial banks, and increasingly on a consumer level, not necessarily as a tool for the poor to use for productive business services as originally intended. Furthermore, attention recently has been

drawn to the very likely possibility that perhaps the majority of the microloans that have been offered by MFIs, for business purposes, have actually gone towards household expenses. Moreover, the overwhelmingly positive claims of the past are beginning to be reconsidered, and some development practitioners have even suggested that microfinance could constrain development.

In order to understand these critiques and to grasp the utility of microfinance, it is necessary to understand the climate from which it has emerged. Through the aftermath of population-encompassing macroeconomic disasters and the neoliberal responses that sustained and sometimes generated increases in informal employment, microfinance has surfaced as the most appropriate response in the resulting economic epoch. The proliferation of microenterprise, fueled by microcredit, has resulted not from a lucrative potential for economic growth, but from the fact that, for the poor and unskilled, few options outside of self-employment exist.

This paper will demonstrate that, in spite of all the excitement and praise associated with microfinance, and the fact that financial services can sometimes improve the lives of the poor, in reality, microfinance and the self-employment it encourages possess little potential for generating the type of macroeconomic growth that can lift populations above the poverty line. Essentially, microfinance has been a neoliberal response to a neoliberal problem. Shifting labor patterns and reductions in meaningful employment have resulted in people being forced

into entrepreneurship, especially within the informal economy, which leaves them vulnerable. A significant portion of the world's self-employed supported by microcredit work in the informal economy, which poses a unique set of problems that need to be addressed. Though microcredit and other financial services offered by MFIs certainly treat *some* of the symptoms of poverty, microfinance alone will not eliminate poverty, and cannot live up to the promises being attached to it within such a celebratory environment.

To give the poor a chance to improve their lives, much more than financial services are needed. Microfinance must be carefully positioned within the puzzle for progress; the hype that microfinance has produced cannot be allowed to siphon funds and attention from other, perhaps more important government-financed development projects in areas like health, education, and infrastructure. While anecdotes and studies have shown that indeed, impressive gains can be made as a direct result of microfinance, it makes up only a partial contribution to a formula for solving the problems faced by the poor. As acknowledged by Yunus: "Poverty is a multi-dimensional phenomenon. It is about people's lives and their livelihoods. To free people from poverty, all aspects of their lives need to be addressed, from the personal level to the global level and from the economic dimensions to the political, social, technological, and psychological dimensions. These are not separate and disconnected elements but closely intertwined" (Yunus, *Creating a World Without Poverty* 75).

Sen explained that development can be seen as a “process of expanding the real freedoms that people enjoy.” His views, worthy of a Nobel Prize, illustrate that social, cultural, and political freedoms are themselves desirable, and also contribute to individual income growth. The productivity and employability of the poor can be enhanced with services such as public safety, basic education, public health, and infrastructure. While access to financial services is one of the freedoms outlined by Sen’s works, it is only one piece of a much larger equation.¹⁴

Importantly, opportunities for improvements in the lives of the poor should not be left largely to market forces, with the chances for success strongly resting on the potential of microfinance-funded entrepreneurship, as often seems to be the case. While previous development strategies modeled on the top-down paradigm have not always succeeded in eliminating poverty, a wholesale transfer of development efforts into the private sector is not the answer. A decision of how to arrange microfinance within the wider scheme of development also must not be left to the market, as increasingly appears to be the case as microfinance becomes more driven by commercial interests.

¹⁴ Economic theory and empirical evidence demonstrate that economic returns are higher when the proper infrastructure and institutions are in place. For example, if a country has poor roads that slow transportation, profits will be diminished throughout the economy, or high shipping expenses will be passed on to the consumer. Similarly, if an area has poor health facilities, productivity will suffer because people will get sick more often and for longer periods of time. Power outages are another problem common in developing countries, costing millions every year in lost productivity. The rate of return to infrastructure projects such as irrigation and drainage, telecommunications, airports, highways, seaports, railways, electric power, water supply, sanitation, and sewage averages from 16 to 18 percent per year. Likewise, the returns to maintenance spending on existing infrastructure, such as roads, are perhaps as much as 70 percent (Easterly 234).

This paper will attempt to put microfinance into perspective, highlighting its limitations in an effort to avoid overly optimistic expectations about its true potential. The goal is not to discount microfinance as a strategy to alleviate poverty and sow the seeds of progress, but to bring to light its drawbacks and its limitations. Microfinance is not a panacea and cannot replace other forms of development assistance. It can be a useful tool to tackle poverty, but it is only one of many, and must be combined with other measures in order to be effective. Most would agree that traditional approaches to development have failed, and some have offered microfinance as the solution to these failures. However, its actual effectiveness, as a substitute or even a complement to traditional development schemes, can be questioned, as this paper will demonstrate.

Microfinance should not be seen as a substitute to government intervention. It will not lead to significant improvement in the type of macroeconomic indicators that economists rely on, such as GDP. Microfinance is more about improving quality of life on an individual level. When it is successful, it brings about an improvement in the freedoms people enjoy. The author's hope is that the phenomenal acceleration and widespread euphoria surrounding the movement does not diminish the potential for well-devised microfinance initiatives, in addition to other effective strategies to eliminate poverty. In order to ensure this, a more thorough understanding of both the full potential and substantial limitations of microfinance is needed.

**LATIN AMERICA (18 COUNTRIES): PERSONS LIVING IN POVERTY AND INDIGENCE,
AROUND 2002, 2006 AND 2007
(Percentages)**

Country	Around 2002			Around 2006			2007		
	Year	Poverty	Indigence	Year	Poverty	Indigence	Year	Poverty	Indigence
Argentina a/	2002	45.4	20.9	2006	21.0	7.2	...	...	...
Bolivia	2002	62.4	37.1	2004	63.9	34.7	2007	54.0	31.2
Brazil	2001	37.5	13.2	2006	33.3	9.0	2007	30.0	8.5
Chile	2000	20.2	5.6	2006	13.7	3.2	...	...	...
Colombia	2002	51.5	24.8	2005	46.8	20.2	...	...	...
Costa Rica	2002	20.3	8.2	2006	19.0	7.2	2007	18.6	5.3
Dominican Republic	2002	47.1	20.7	2006	44.5	22.0	2007	44.5	21.0
Ecuador a/	2002	49.0	19.4	2006	39.9	12.8	2007	38.8	12.4
El Salvador	2001	48.9	22.1	2004	47.5	19.0	...	...	...
Guatemala	2002	60.2	30.9	2006	54.8	29.1	...	...	...
Honduras	2002	77.3	54.4	2006	71.5	49.3	2007	68.9	45.6
Mexico	2002	39.4	12.6	2006	31.7	8.7	...	...	...
Nicaragua	2001	69.4	42.5	2005	61.9	31.9	...	...	...
Panama	2002	36.9	18.6	2006	29.9	14.3	2007	29.0	12.0
Paraguay	2001	61.0	33.2	2005	60.5	32.1	2007	60.5	31.6
Peru b/	2001	54.7	24.4	2006	44.5	16.0	2007	39.3	13.7
Uruguay a/	2002	15.4	2.5	2005	18.8	4.1	2007	18.1	3.1
Venezuela (Bol. Rep. of)	2002	48.6	22.2	2006	30.2	9.9	2007	28.5	8.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the relevant countries.

a/ Urban areas.

b/ Figures compiled by the National Institute of Statistics and Informatics (INEI) of Peru. These values are not comparable with those of previous years owing to changes in the sample framework used in the household survey. In addition, the figures given for 2001 correspond to the fourth quarter, whereas those shown for 2006 and 2007 correspond to the entire year.

(ECLAC 11)

A Paraguayan context

Many of the ideas presented in this thesis are derived from two months spent in Paraguay working as an intern at the country's largest NGO, *Fundación Paraguaya* (FP), a well-respected, non-profit organization that provides microfinance and various social services to those in need.¹⁵ FP operates out of

¹⁵ FP was the first NGO of its kind in Paraguay. The organization has received numerous recognitions, including the IDB Award for Excellence in Social Entrepreneurship, the Schwab Foundation Award, and an Honorable Mention from CGAP for financial transparency. FP is

seventeen regional offices serving 136 towns and cities throughout the country (www.fundacionparaguaya.org.py). In these two months, I had daily interactions with microentrepreneurs, credit officials, and other MFI employees in diverse urban and rural settings. Most of the time was spent working on projects at one of the more financially successful branch offices in San Lorenzo, an area right outside of the capital city, Asunción. Additional time was spent in the main office in Asunción and on a trip across the countryside with the director of the rural microfinance program.

Fundación Paraguaya de Cooperación y Desarrollo (Paraguayan Foundation for Cooperation and Development) was founded in 1985 by a group of national business leaders, including Executive Director Martin Burt, out of frustration with the “then-dictatorship’s inability to tackle problems of severe poverty, and its lack of support for those wishing to work their way out of it.” Originally, the idea was to improve the business skills of microentrepreneurs, but when it became obvious that a lack of credit, rather than skills, was limiting their growth, a partnership with ACCION International was established to begin to offer microfinance services (www.fundacionparaguaya.org.py).

The objective of FP’s microfinance programs are to “promote the development of micro and small enterprises along with people of scarce means through the creation, expansion, and strengthening of sustainable lending, training

included as a Champion in the Microfinance Information eXchange (MIX)’s “League of Champions” for standing out in terms of results and transparency. In 2005 FP was distinguished as the sixth most profitable MFI in Latin America (Fundación Paraguaya, Awards Received).

and advisory services.” The foundation has provided technical assistance, management training and loans to more than 36,000 microentrepreneurs in over 90 different types of urban and rural microenterprises, including small grocery stores, street vendors, taxis, homemade food producers, garment makers, artisans, blacksmiths, and farmers, among others. FP claims that statistics supported by independent research suggest that approximately 23,000 jobs have been created, at a ratio of 1.3 job per microenterprise supported for over one year (www.fundacionparaguaya.org.py). According to ACCION, a global microfinance network, most FP loan recipients work in the commercial sector; 28 percent own small stores and 18 percent work in the food industry. Fifty percent of the microenterprises have between two and four employees and 46 percent have just one employee (Acción, Where We Work: Fundación Paraguaya).

FP offers several credit products, ranging from \$40 for the small entrepreneur to \$15,000 for commercial and industrial ventures. Loans are usually targeted towards small microentrepreneurs, especially in the informal sector; the average loan is less than \$450, which is \$150 less than the average loan offered by competitors (www.fundacionparaguaya.org.py). Training and other services also are provided, as the foundation prides itself on being a development entity more than a financial entity. The MFI program goals are to: increase family income, strengthen precarious jobs, promote job creation, improve gender equity, and promote entrepreneurship (www.fundacionparaguaya.org.py).

The organization aims to be entirely financially independent, and in the case of individual microlending, achieves this goal. Surpluses generated through individual microlending operations are funneled into other FP programs meant to create synergies with one another, such as lending to women's groups (Women Entrepreneurs Committee, or *Comite de Mujeres* (CME), established in 2005), rural microlending (established in 2001 with the support of the Inter-American Development Bank (IDB)), entrepreneurial training for the young (Junior Achievement, etc.), the world's first (ostensibly) self-sufficient rural agricultural school (San Francisco Agricultural School), and other services important in a developing country.

Fundación Paraguaya Program Growth:

Year	Active Portfolio	Amount Disbursed	Active Clients	Average Loan Balance
2002	\$2,000,000	\$3,868,000	6,015	\$333
2003	\$2,440,000	\$3,758,000	7,076	\$345
2004	\$2,736,934	\$5,254,921	6,529	\$419
2005	\$4,196,464	\$7,416,353	9,259	\$453
2006	\$6,003,000	\$10,679,000	19,473	\$308
2007	\$9,100,000	\$14,400,000	24,896	\$367
2008	\$11,309,000	\$25,161,000	34,222	\$330

(Acción)

Of the countries in Latin America, Paraguay is an exceptional area to study microfinance. Its low measures of human and economic development put it behind all but a few countries in Latin America, while its informal economy and high levels of corruption draw parallels with underdeveloped countries in poor parts of Asia and Africa, many of which are faced with far greater poverty concerns than most of Latin America. Furthermore, the high levels of self-employment in the informal economy make it a country that should, in theory, be especially responsive to the gains that can be realized through microfinance.

Estimates suggest that between one-third (World Bank Poverty Assessment) to one-half (2003 Census Bureau Household Survey) of the population of Paraguay is poor. In rural areas, 41.2 percent of the population lacks a monthly income to cover basic necessities, while in urban areas this figure is 27.6 percent. Nationally, the top 10 percent of the population possesses 43.8 percent of the national income, while the lowest 10 percent has just 0.5 percent. Furthermore, land concentration in Paraguay is among the highest in the world. Just 10 percent of the population controls two-thirds of the land, while 30 percent of the rural population is landless (Carter, Gacitúa Marió and Silva-Leander vi)

Several key observations planted the seeds for this research:

1. Many, if not most microloans are used to “*sobrevivir*,” or to survive, by bridging gaps in income and running small enterprises on a subsistence level. Rarely do loans enable borrowers to significantly expand their businesses, hire workers, and achieve prosperity. Widely publicized stories of microentrepreneurs who have been able to make substantial improvements in their lives using microloans appear to be the exception, rather than the rule.
2. Of FP’s clients in the individual lending program, the majority of those in the middle class are there because they began there, not because a microloan propelled them there. For an individual to receive a microloan for business, an enterprise must have already been established.
3. Few options aside from informal self-employment exist in Paraguay, especially for the unskilled with low educational attainment. The easy entry, especially when enabled by microfinance, makes self-employment a relatively attractive option.
4. A substantial portion of Paraguay’s microentrepreneurs operate identical microenterprises, competing in highly competitive markets with low returns, unable to reach economies of scale.
5. The tools for microentrepreneurial success are not in place in Paraguay. Regulatory reforms in multiple areas need to be enacted,

which, among other things, should provide more of an incentive for regulation and make it a less prohibitive option for microenterprises. These reforms must accompany significant improvements in the legal system. Legal and regulatory improvements would greatly enhance the potential for microfinance to play a part in Paraguay's development.

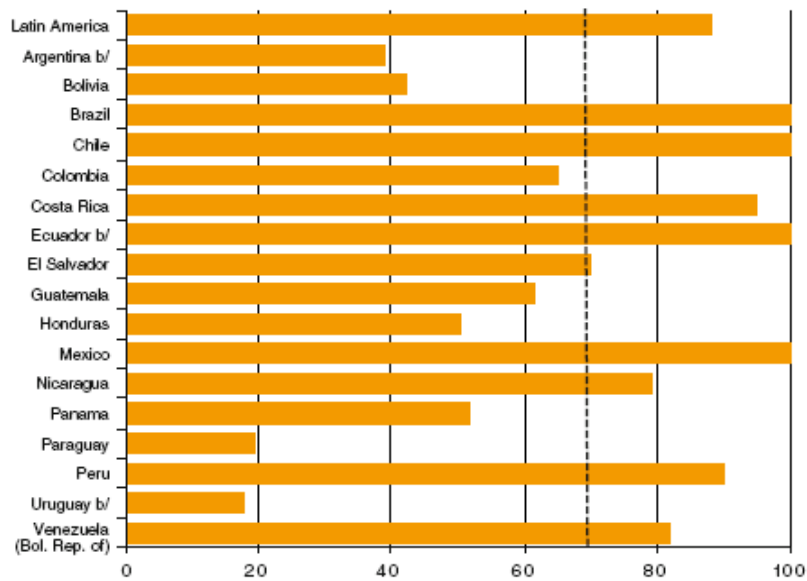
6. Substantial, well-planned government intervention is necessary for Paraguay's economic and social development. Corruption must be greatly reduced for this to happen.

Paraguay

- Population of 6.2 million
- 101st in HDI
- 14.2% of the population lives below \$2 per day
- 6.5% of the population lives below \$1.25 per day
- Adult literacy is 93.5% for females and 95.7% for males
- GDP per capita is \$1,997
- GDP per capita growth rate of -0.3% from 1990-2007
- Combined gross enrollment ratio in education is 72.2% for females and 72.1% for males
- 82nd in Gender-related development index (GDI)

(UN Human Development Report 2009)

LATIN AMERICA (17 COUNTRIES): ADVANCES IN REDUCING EXTREME POVERTY BETWEEN 1990 AND 2007 a/
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the relevant countries.

a/ The amount of progress made (expressed as a percentage) is calculated by dividing the percentage-point reduction (or increase) in indigence registered during the period by one half of the indigence rate for 1990. The dotted line represents the amount of progress expected by 2007 (68%).

b/ Urban areas.

(ECLAC 15)

A HISTORY OF MICROFINANCE

Introduction

To effectively analyze the potential of microfinance, and the euphoria that surrounds it, it is necessary to be cognizant of the historical trends of economic development. In spite of all the hoopla surrounding microfinance, putting the strategy into historical context should rein in a good deal of the optimism associated with the movement. In the past, too much reliance on a promising, singular solution has repeatedly failed. In an effort to learn from and avoid repeating the mistakes of the past, it is necessary to recognize that microfinance is not a silver bullet for poverty, but only a small, yet integral, part of an equation that can abate it. It should be looked at through a historical lens of limited progress, marked with years of failure. Careful scrutiny must accompany the movement in order for it to continue to effectively combat poverty and have the greatest possible impact.

Development studies and development economics designed to lift poor countries and their inhabitants out of poverty date back to the post World War II era. At that time, it was demonstrated that, through human intervention, lives could be improved on a significant scale. The success of the Marshall Plan in Europe led to the implementation of similar interventions of wide-ranging scope across the developing world, in spite of the fact that many of these countries were not rebuilding, but developing for the first time. The end of the colonial era, in

tandem with long lasting attempts to thwart the spread of communism, especially brought the importance of development to the forefront in the eyes of policymakers. Throughout the 1950s to the early 1970s, development initiatives mostly took place from the top-down, with continuous focus placed on industrial development as a way to catch up with the West through replication and imitation.

This era was marked by the public ordering of the economy, as popular belief held that it was the government's job to guide development. This led to economies being planned by the state, and the close regulation of the private sector. Throughout the developing world during this era, state enterprises flourished. In Latin America, import-substitution industrialization (ISI) policies were the vanguard, and government enterprises were seen as the fundamental engines of development. This era was characterized by closed economies and economic self-reliance, manifested in high tariffs, restrictions on foreign investment, and tight controls over foreign exchange (Dañino, Genta-Fons and Salacuse 441-442).

During this time, the developed world's attempts to facilitate economic growth in the Third World, as it was then known, consisted mainly of aid.¹⁶ This early and long-lasting (until today) strategy emerged after World War II, based on the empirical success of the rebuilding of Europe and the idea that aid-financed investment in dams, roads, and machines would yield growth (Easterly, The

¹⁶ Of the \$30.4 billion spent on foreign aid between 1948 and the mid-1950s, 77 percent went to U.S. suppliers (Dichter, *Despite Good Intentions* 57).

Elusive Quest).¹⁷ Economists at the time relied on models based on popular economic thinking of the era.¹⁸ “The method of argumentation was virtually always the same. The subject was material well-being, indicated by measurable income per capita. The conceptual tools were taken overwhelmingly from economic science...the logic was applied “universally” across the spectrum of “developing countries,” with little allowance or variation for their evident differences in size, history, cultures, natural endowments, etc.” (Bangasser 2-3).

In Latin America throughout the 1960s and 1970s, many countries, especially the larger economies such as Brazil, Mexico, and Argentina, followed the economic mindset of the time by borrowing heavily from international creditors for economic development in the form of industrialization. The countries had quickly growing economies at the time, so credit was widely available for these industrialization efforts, which consisted mainly of infrastructural programs. Multiple figures indicate that from 1950 to 1983, the region’s external debt quadrupled, culminating in an amount of about 50 percent of the region’s GDP. Just between 1970 and 1980, Latin America’s foreign debt

¹⁷ Theoretically, this strategy was largely based on an article on economic growth published by Evsey Domar in April 1946 titled “Capital Expansion, Rate of Growth, and Employment.” Domar’s growth model became, and continues to be today, the most widely applied growth model in economic history. As Easterly pointed out, it continues to be applied to this day to poor countries in order to determine a “required” investment rate for a target growth rate, even though the model was not intended as a growth model, made no sense as a growth model, and was disavowed by Domar himself back in 1957. Easterly noted that Domar’s approach became popular because it had a conveniently simple prediction: GDP growth will be proportional to the share of investment spending in GDP (Easterly, *The Elusive Quest* 28-29).

¹⁸ This included theory based on economic literature such as Raul Prebisch’s “center vs. periphery” (1949), Arthur Lewis’ “unlimited supplies of labour” (1954), Harvey Leibenstein’s “big push” (1957), and W. W. Rostow’s The Stages of Economic Growth (1960), which went through thirteen printings between March 1960 and November 1965 (Bangasser 2-3).

doubled (Ugarteche 201). Simultaneously, debt service of interest and the repayment of principal grew at an extremely rapid pace.

With rapidly rising oil prices in the 1970s and early 1980s, and the triggering of a global recession, the massive accumulation of Latin American debt could not be easily repaid. This was brought to light in August of 1982 when Mexico's Finance Minister declared that Mexico would no longer be able to service its debt in a timely manner. As a consequence, most commercial banks either drastically reduced or stopped lending to Latin America.

Due to the fact that many of the loans were short-term, a crisis followed when their refinancing was not accepted. Billions of dollars of loans became due immediately, triggering widespread and long-lasting financial calamity in the region. Between 1980 and 1990, economic growth in Latin America stagnated and the region exported \$375 billion for debt servicing, despite which the debt doubled again due to compounding interest (Ugarteche 201). These results, which rippled throughout the whole of the region and the world, led to the 1980s being referred to as "The Lost Decade" for Latin America.

By 1980, development strategies had begun to take a considerable turn. The World Bank, who has always been a trendsetter and the most important player in the field of development, began imposing conditions on economic policies to countries in crisis, rather than just conditions on particular projects, as they had in the past. This structural adjustment lending, as it was called, was

meant to induce loan recipients to adjust their macroeconomic policies to promote growth, while providing needed money in the absence of commercial lending (Easterly, *The Elusive Quest* 102). Many observers see this as the Bank abandoning its role as a development bank and becoming a policy-making institution that intervenes in the internal affairs of countries. The IMF had always attached conditions to its loans, and after 1982 began to expand the number and lengthen the maturity of loans. Aid donors and official creditors also began to make their grants and loans more conditional by coordinating their lending with the IMF and the World Bank (Easterly, *The Elusive Quest* 102). By the mid-1980s, the models that had led to the debt crisis were being abandoned worldwide, replaced by a “new superstition.”¹⁹

Across the region, planners and government officials, influenced (or by some observations, coerced) by the IMF and World Bank, shifted almost wholesale to what is typically called the “neoliberal” era. The market-based paradigm of the neoliberal model was essentially what the previous state-led model was not; it abandoned strict planning and left it to the invisible hand of the

¹⁹ Stiglitz wrote that, when he moved from the domestic into the international arena, he found that, especially at the IMF, “Decisions were on the basis of what seemed a curious blend of ideology and bad economics, dogma that sometimes seemed to be thinly veiling special interests. When crises hit, the IMF prescribed outmoded, inappropriate, if “standard” solutions, without considering the effects they would have on the people in the countries told to follow these policies. Rarely did I see forecasts about what the policies would do to poverty. Rarely did I see thoughtful discussions and analyses of the consequences of alternative policies. There was a single prescription. Alternative opinions were not sought. Open, frank discussion was discouraged—there was no room for it. Ideology guided policy prescriptions and countries were expected to follow the IMF guidelines without debate” (Stiglitz, *Globalization and its Discontents* xiii-xiv).

market to allocate resources, particularly credit and foreign exchange, and spur development. This meant an abrupt shift from closed to open economies, including an overall strategy of deregulation, which meant a reduction of trade barriers and reduction in the size of government, the privatization of state-owned industries, and lifting restrictions on the movement of capital. Together these strategies made up the prescriptions known as the Washington Consensus or neoliberal or free market reforms. The planning and persuasion for these reforms, which ostensibly are meant to stabilize economies and encourage growth, have been formulated especially by actors in developed economies. Most often, neoliberalism has been a disaster for the world's poor.

Tracing the roots of microfinance

The beginnings of microfinance, in the form of both formal and informal financial services for the poor, can be traced back quite some time throughout the world. Rotating savings and credit associations (ROSCAs) existed in China 1,500 years ago (Peace Corps 46). As early as the 1300s, forms of microfinance and collective lending existed in the *susus* of Ghana, *chit funds* in India, *tandas* in Mexico, *arisan* in Indonesia, and *tontines* in west Africa (Hartford np). In Europe, as early as the 15th century, Franciscan monks in Perugia, Italy would lend money to the poor in times of crisis, and as collateral would hold some precious items to cover their operating costs. This idea, reminiscent of modern

pawnshops and referred to as a “Fund of Mercy,” was endorsed by the Pope and spread widely (Hartford np).

Additionally, the Irish Loan Fund System was launched in the early 1700s to provide small loans to poor farmers with no collateral, and at its peak was lending to 20 percent of all Irish households every year (Helms 2-3). Later on, in 1865, Friedrich Wilhelm Raiffeisen developed the concept of the credit union, which expanded across several regions of the world beginning in 1870 (Hartford np). Many modern financial cooperatives in Africa, Latin America, and Asia trace their roots to European movements such as these. Another early example of microfinance in Asia is the Indonesian People’s Credit Banks, which was opened in 1895 and with close to 9,000 branches today, has become the largest microfinance system in Indonesia (Helms 3).

Access to credit has historically not been available to, and even explicitly restricted from the masses for various reasons. In Europe, the Christian Church’s dogmatic conventions upon usury forbade Christians from lending money out at interest. In that part of the world, Jewish bankers stepped in to fulfill the demand for credit, and though ostracized, profited greatly from lending. Over time, with the evolution of the Medici Bank in the 15th century and breakthroughs in finance (such as government bonds to fund war), moral restrictions against certain forms of finance faded and charging interest on loans became more widely accepted.

Modern overview

“Microfinance” had usually been called “microcredit” until the early 1990s because it traditionally entailed only small loans made to the poor. As the range of services provided has increased to include insurance, money transfers, savings, and more, the term “microfinance” has been used to encompass this range of small-scale financial services. Many other terms are used, often interchangeably, with the word microfinance. These include barefoot banking, microlending, microbanking, and microloans, among others (Helms 3).

In the modern world, there are several principal reasons the scope and number of institutions providing needed financial services such as credit, savings, and insurance to the poor have been limited. The following stylized facts, as outlined by Jansson and Taborga and Woller and Warner, have left the majority of the world’s poor starved for the credit necessary to open or expand businesses or utilize other financial services that can lead to improvements in well-being:

- Banks face relatively high transaction costs when working in poor communities because handling many small transactions is far more expensive than servicing fewer, larger transactions.
- Microloans are often repaid in weekly or biweekly installments, which make operating expenses high. (Operating expenses (relative to assets) of specialized MFIs are generally at least 60 percent higher than for commercial banks) (Jansson and Taborga).
- The poor typically do not possess collateral.
- There is a lack of information in poor communities, which makes risk assessment especially difficult. The costs involved with screening and monitoring the activities of the poor and enforcing

their contracts are often seen as too high to make lending to them profitable.

- The poor have not typically been considered likely entrepreneurial candidates.
- Many of the world's poor work in the informal economy (Woller and Woodworth 271).

Regarding insurance, savings, and consumer credit, there are wide differences between countries and regions in which types of services are offered. Medium income countries such as Mexico or Brazil are more inclined to offer consumer credit and savings, while MFIs in poorer countries tend to focus on credit to stimulate entrepreneurship. In the last several years, some MFIs, especially those driven by profit, have begun to place more emphasis on consumer loans, in both high and low income countries.²⁰

The microfinance movement

In contemporary times there is one microfinance narrative that stands out above all. The story of Yunus and the founding of the Grameen Bank have been disseminated through academic texts, mainstream news outlets, and Yunus' autobiographical New York Times bestselling book, Banker to the Poor: Micro-

²⁰ Banking sector outreach varies significantly across countries. In Ethiopia there is less than one branch per 100,000 people, while in Spain there are 96. In Albania, there are four loans per 1,000 people and the average loan size is fifteen times GDP per capita, while in Poland there are 774 loans per 1,000 people and the average size of loans is only one-third of GDP per capita (Beck, Demirguc-Kunt and Martinez Peria, Reaching Out 2).

Lending and the Battle Against World Poverty,²¹ which was followed by Creating a World Without Poverty: Social Business and the Future of Capitalism. What is perhaps the most fabled story in the field of contemporary development began when Yunus, a Bangladeshi economist educated at Vanderbilt University, began experimenting with small loans to impoverished villagers in Bangladesh in 1976. He first lent \$27 out of his pocket, which the recipients used to run simple business activities such as rice husking and bamboo weaving.²²

After some initial success, Yunus eventually convinced the central bank of Bangladesh to help him set up a special branch to cater to the poor in the town of Jobra. The project soon flourished, assisted with funding provided by the International Fund for Agriculture and Development, the Ford Foundation, and the governments of Bangladesh, Sweden, Norway, and the Netherlands. The Grameen Bank grew to include over one million members in 1991 (Armendáriz and Morduch 2, 11-12) and seven million by 2006 (Yunus, *Creating a World*

²¹ Yunus' *Banker to the Poor* spent ten weeks on the New York Times bestseller list.

²² Though Grameen Bank was one of the earlier MFIs, organizations such as Acción Internacional, founded by Joseph Blatchford in Venezuela, actually predated Yunus by a few years (1973). Other early pioneers included Al Whittaker and David Bussau, who began lending to microentrepreneurs in Indonesia and Colombia in 1971 (Hartford np). Another pioneer is Projeto Uno in Recife, Brazil, which offered small loans to microenterprises beginning in 1972. This MFI introduced the concept of young, proactive loan officers who developed personal relationships with the clients and were responsible for all aspects of the loan cycle, from start to finish (Berger, *The Latin American Model of Microfinance* 9). FINCA, another prominent Latin American MFI that has spread throughout 21 countries, is credited with pioneering the village banking model. It was launched in 1984 by John Hatch, a former Peace Corps volunteer and Fulbright-trained economist. FINCA started as a program in Bolivia that provided credit to farmers without collateral, and in 1986 began to provide loans to women involved in commerce and petty trade in El Salvador (FINCA, *Narrative History*).

Without Poverty 51-52). In Bangladesh, 80 percent of poor families have been reached with microcredit (Yunus, *Banker to the Poor* 66).²³

It is important to be aware of the Grameen story when assessing the state of microfinance today, as Grameen truly envelopes the social philosophy upon which microfinance was originally based, and is often the measure against which other MFIs are compared. The accomplishments of the foundation are phenomenal, especially considering its humble origins and the numerous political complications and devastating environmental disasters it has survived. Due to its success in reaching poverty-stricken populations, Grameen's platform has been replicated throughout the world, including the U.S., and today the bank is widely considered to be one the world's most successful institutions that works with the poor.²⁴ Grameen has also launched Grameen Foundation, an organization that works throughout the world to tackle poverty, using various types of unique initiatives outside the realm of microfinance.

The Bank's success largely has to do with the founder's philosophy and vision. Yunus grew up in Bangladesh and has always maintained a close relationship with the poor. As a Bangladeshi, he has witnessed the failures of development initiatives firsthand, and therefore has evolved a sound

²³ In 2006 Grameen Bank earned a profit of \$20 million and distributed dividends for the first time, to borrowers who were considered shareholders of the bank (previous government-imposed restrictions had been lifted). Yunus claims a repayment rate of 98.6 percent, and that 64 percent of the borrowers that have been with the bank for more than five years have surmounted the poverty line (Yunus, *Creating a World Without Poverty* 51-52).

²⁴ While Yunus claims 100 percent sustainability, it took Grameen years of substantial funding from outside actors to reach this point, and the bank pays no corporate tax.

understanding of what it takes to make a difference in the lives of the poor. In Banker to the Poor, he explains that

...wherever a poverty alleviation program allowed the nonpoor to be co-passengers, the poor would soon be elbowed out of the program by those who were better off. In the world of development, if one mixes the poor and the nonpoor in a program, the nonpoor will always drive out the poor, and the less poor will drive out the more poor, unless protective measures are instituted right at the beginning. In such cases, the nonpoor reap benefits of all that is done in the name of the poor...The poor know that this credit is their only opportunity to break out of poverty. They do not have any cushion whatsoever to fall back on. If they fall afoul of this one loan, they will have lost their one and only chance to get out of the rut. (Yunus, Banker to the Poor 42,58)

Grameen prides itself in treating each impoverished individual as a fully equal member of society, avoiding the paternal approach often recounted by those receiving assistance from organizations such as the World Bank. “In a modern economy, each economic entity or group has its own engine. The combined power of the engines pushes and pulls the economy forward. The power will be reduced if those in the back are ignored” (Yunus, Banker to the Poor 212). In Yunus’ book, he explains that he expects a lot out of the loan officials, and is upfront about the work. The loan officials must be prepared to understand the mentality of the poor and to spend time working with the destitute while working and living in harsh conditions (Yunus, Banker to the Poor 134).

The Grameen system also owes much of its early success to its simple formula for repayment mechanisms (which has since been fine-tuned). Loans last

one year, installments are paid weekly, repayment rates start one week after the loan, interest rates are 20 percent, and repayment amounts to 2 percent of the loan amount per week for 50 weeks (Yunus, *Banker to the Poor* 68-69). In addition, Grameen assumes every borrower is honest. Prior to Grameen, women constituted less than 1 percent of all borrowers in Bangladesh, whereas women make up 96 percent of Grameen's borrowers (Tharoor np).

As a result of the pioneering success of Grameen, Yunus has become the outspoken face, and even salesman, for the microfinance industry, as well as for the field of development in general. At the Committee of Donor Agencies for Small Enterprise Development's June 1988 international meeting in Washington, Yunus was the principal speaker. Ditcher has explained that at the meeting, the debate between technical assistance versus credit became more pronounced, and "...NGOs were called upon as naturals to provide credit to the microenterprises run by the very poor," because it was assumed that "they were ideologically motivated and, as grassroots practitioners, appropriately positioned. Banks and governments, it was claimed, could not be counted upon to reach the poor effectively." A new type of financial intermediary, the MFI, came to be discussed more widely during this time (Dichter, Introduction 3).

Shortly thereafter, experiments in microfinance began to spread, and the World Bank began to take interest. In the 1990s, there was a push to make microfinance practices more business-like. CGAP was formed in 1995 by a

group of major donors and created a secretariat housed at the World Bank.²⁵ There were a series of exhaustive manuals produced, and some academics became interested in studying microfinance. Within the industry, the focus began to be as much on the lender as on the beneficiary (Dichter, Introduction 4).

In recent years, a uniform set of “best practices” has evolved and been promoted across the world. At times, these “best practices,” which embody the microfinance methods used by successful MFIs, have been copied in other regions, sometimes without significant attention devoted to unique social, economic, and political environments. Many observers note that these attempts at replicating “best practices” have been mostly disappointing.

²⁵ Contributing institutions included the United States Agency for International Development (USAID) and the UN. CGAP originally stood for the Consultative Group to Assist the Poorest, but in 2003 the word “Poorest” was substituted with “Poor” (Dichter, Introduction 4-5).

MICROFINANCE OPERATIONS

There are a wide variety of microfinance operations found in the world, across and within regions. This includes great heterogeneity in terms of market penetration, supply, services, mission and philosophy, financing, lending methodology, organizational structure, and other characteristics. The proceeding chapter provides an outline of the most common types of lending platforms, followed by the most common structures for MFIs.

Group lending

The group lending model, practiced by early MFIs, is what brought microfinance into the development lexicon. The vast majority of worldwide microfinance operations, especially as practiced by NGOs and in rural areas, use the group lending method. There are multiple variations of the group lending model, including village banking, ROSCAs, credit unions, and other structures, all of which share similar characteristics and approaches to the same goals. In Latin America, this model is far less prevalent than in other parts of the world, comprising only about 10 percent of microlending, about half of which are customers of Compartamos in Mexico (Berger, The Latin American Model of Microfinance 14).

Typically, the group lending model is carried out by administering a single loan to a group, then dispersing portions of the loan among individual members of the group for their specific needs. Each member gets a portion of the loan for their own business, and if one member fails to pay, in most cases the rest of the group is required to cover their payment (this effectively clouds actual repayment rates). The group lending model especially is important for the poorest members of society and for females, due to the fact that they typically lack collateral and possess little, if any, credit history. For the same reason, group lending is also the most effective means to reach people in rural areas.

This shared risk is advantageous for the loan portfolios of MFIs, and is the reason that high repayment rates are maintained. Social pressure is a strong deterrent to missing a payment. If a group wants to ensure the availability of future credit, each individual's loan portion must be repaid. One reason this system is advantageous is because of the ability it has to utilize local knowledge of the risks involved with lending to specific individuals. MFIs often report that the most important reason for failure of repayment is when the loan is used for things other than which it is intended. Because members of a group monitor one another, group lending is meant to mitigate such situations. The downside, however, comes with the fact that groups may exclude the poorest members of the community, whom they may consider unfit to repay.

One of the reasons group lending is so common, especially with NGOs, is that much of the management takes place within the group, eliminating the need for employee hours spent in activities such as analyzing risk and collecting and disbursing individual payments. Ultimately, the main advantage of this model is that it replaces collateral with a shared risk, utilizing collective responsibility and peer pressure as a means of assuring repayment. Under this model repayment rates below 95 percent are typically considered unsatisfactory, and repayment rates nearing 100 percent are common.

Village saving and loan associations, which are one of the oldest forms of microfinance and have been around for centuries, are a variant of the group lending model. This platform is often, though not necessarily, categorized as microfinance. These organizations usually consist of 15 to 30 people who pool their savings, then borrow from the collective funds. These organizations are highly democratic; all transactions occur in front of the group, funds are usually kept in a box with multiple locks, and keys are held by different members. The group sets the interest rate, all interest is returned to the box, and at the end of year the group performs an ‘action audit’ and distributes resources to members. Because of high interest rates on loans, returns on savings are typically 30 percent or more. All funds stay within the group, and while these organizations don’t necessarily require an official MFI, most are managed by local NGOs (Rippey 119).

Credit unions, or Rotating Savings and Credit Associations (ROSCAs) share basic characteristics with village savings and loan associations. In this system a number of people form a group and contribute an agreed amount on a regular basis. At each meeting the fund is usually given to one person who takes all the money, until everyone in the group has received the money in turn. Every transaction occurs during meetings in front of every member. The order of rotation may be determined by ballot, by age or seniority, or other social systems of preference. This is an attractive method especially due to its simplicity and transparency.

Non-profit credit unions and ROSCAs, which have no external shareholders, are similar to microfinance NGOs in that their mission and priority typically is to service the needs of the poor. They are usually registered entities subject to commercial laws, but are not typically regulated or supervised under banking laws. These organizations are member-owned and provide financial services only to members. Usually this includes savings and loan services, and in some cases insurance as well. Membership in a credit union has traditionally been based on a common bond such as shared employment or membership in the same community. Therefore, this approach entails substantial member participation (Montgomery and Weiss 31).

In the most popular group lending model, as practiced by Grameen and FP, members of a (normally) self-selected group of a predetermined size receive a

loan in a lump sum, then the credit is dispersed amongst the individual members, under the supervision of a credit official, or an *asesora* as FP terms it.²⁶ Many times the credit is explicitly intended to launch a new small business venture, while other times the business may already exist. At Grameen, all the members of the group of five prospective borrowers have to present themselves at the bank, undergo at least seven days of training on policies, and demonstrate their understanding of those policies in an oral examination administered by a senior bank official. Yunus points out that each of the members must be individually tested, and it can take anywhere from a few days to several months for a group to be recognized and certified by Grameen Bank (Yunus, *Banker to the Poor* 63).

In FP's CME program, which uses the group lending platform, an interested group of women is first given a presentation about the program by an *asesora*. After deciding to work with CME, there are four meetings that the self-selected group of at least 15 members must attend. This includes an initial informative meeting, a meeting in which the women choose a name for their group and elect officers, a signing meeting in which the group prepares for hypothetical problems that could arise, and a final meeting to complete the remaining paperwork and set schedules for the group. The final meeting includes

²⁶ FP's *asesoras* tend to be women in their early 20's, many of whom are attending college. Their position requires them to complete administrative tasks involved with lending, provide training, and to command a group of women often more than twice their age during committee meetings, acting as an intermediary to solve problems with issues such as members not repaying their loans. At times, these meetings become very heated. FP's *asesoras* are paid significantly less than credit officials for the individual lending program.

a meal or symbolic gesture amongst the women, which is meant to establish a bond between them (Heter 51-52).

After the fourth meeting, the group is eligible to take out a loan. It usually does so within one week of the final meeting, and this requires all loan recipients to travel together to the regional office to individually sign for their portion of the loan and to present their national identification cards. From then on, payments are made on a weekly basis, and loans can be distributed in cycles from 12-16 weeks. In addition, obligatory group savings are collected and deposited in a financial institution chosen by the group (due to regulations that limit NGOs from accepting deposits, FP cannot collect savings itself) (Heter 52).²⁷

Individual lending

Individual lending, which is the most prevalent type of microfinance in Latin America, is usually similar to lending operations carried out by traditional, formal banking institutions. Especially within the last several years, individual loans for microenterprise and consumer purposes have increasingly been offered by MFIs, throughout the world. In this model an individual is solely responsible for the payment of their own loan, and the procurement of credit is usually based upon past credit history, references, collateral, and the type and validity of

²⁷ Beginning in August of 2008 FP was beginning to implement significant changes in the CME program.

business venture. In this system MFIs are generally less discerning and formal than a typical commercial bank would be. Usually, instead of a formal risk analysis, credit officials conduct informal interviews with the entrepreneurs and are expected to be familiar with the individual's situation and business.

Individual microlending is most often implemented by MFIs that are more commercially oriented, and is the most common method found in urban settings. In recent years, many MFIs, including non-profit MFIs and even the new Grameen II system, have shifted towards individual lending operations in order to satisfy demand and take advantage of its flexibility in loan terms and amounts.

The majority of FP's clients are served by individual lending. Operations are essentially the same as those found at commercial banks, and a credit check is usually performed in order to ensure a client's reliability. Interest rates for the individual lending program are around 40 percent, and profits serve to subsidize other FP programs. In individual lending operations at FP, a business must have already been established in order to receive credit. Often, collateral is a requirement for an individual to get a loan. The courtyard at the San Lorenzo office housed several pieces of collateral, including a motorcycle and a washer and dryer.

One drawback attributed to this model is that it may leave out the poorest individuals, who typically cannot provide the collateral required. Also, MFIs targeting individual borrowers face higher transaction costs when offering small

loans to individuals. The 2005 Microbanking Bulletin database showed that average loan amounts range from almost \$1,000 for individual lenders, \$370 for smaller groups, and \$136 for larger groups. About 90 percent of the members of the larger groups are women, but over half the individual borrowers are men (Harper 38-39).

MFI Structures

	NGO	Credit union	Commercial bank
Target clients	The poor, especially disadvantaged groups	Members	All small clients, particularly microenterprises and traders
Primary source of funds	Donors	Members	Depositors, investors
Strengths	Deep outreach (strong poverty focus), credit combined with training and support	Participatory, access to remote rural areas	Savings mobilization, access to commercial funds and regulation to ensure prudential operations
Weaknesses	Limited sources of funds for expansion, governance issues and management standards	Governance issues, managements standards and outreach limited to members	Mission drift and exclusion of poor and constraint on expansion because of prudential requirements.

(Montgomery and Weiss 34)

In addition to a variety of differences in lending methodology, there are also a wide range of organizational and legal structures among MFIs, each possessing unique advantages and disadvantages. Historically, microfinance

projects have typically begun with seed money from donors or locally subsidized projects, making the NGO the most common MFI legal structure found today (Arvelo, Bell and Novak 131). The poverty-alleviating success of the NGO approach to microfinance, practiced by early pioneers such as the Grameen Bank in Bangladesh, is what has catalyzed worldwide interest among development thinkers. On the other hand, commercial success demonstrated by MFIs such as Compartamos in Mexico or the NGO-turned commercial bank BancoSol (formerly Prodem) in Bolivia have sparked interest from the business sector.

There are several advantages of NGO status. For one, NGOs avoid heavy taxation or intervention from regulatory government agencies. Most NGOs are sustained by subsidized loans, donations, and grants, so they are able to focus more on improving lives and less on adhering to bureaucratic regulations in areas such as accounting or tax procedures. The NGO label ensures that the institution is trying to fulfill a social mission, which makes it easier to secure philanthropic funding if needed (Arvelo, Bell and Novak 131). NGOs also are more closely able to assess the needs of the local poor, and commonly provide training and education when disbursing loans, as well as a range of other services poor communities benefit from. They also do more to reach the poorest of the poor, and more often have penetrated rural markets that commercial MFIs typically avoid due to high operating costs. There are numerous extra costs associated with providing financial services to individuals in rural areas, who are often the poorest

members of society. These difficulties include language or cultural barriers, weak telecommunications and infrastructure, and especially distance.

The NGO approach also has several major drawbacks that are frequently discussed. The main disadvantage is that, due to existing laws, the NGO status generally limits the types of financial services that can be provided. Most important among these disadvantages is the fact that in most countries, NGOs cannot legally offer savings services, which are in very high demand. This limits their ability to use client deposits as a way to finance other parts of the organization's operations, which can limit their scale of operations. The ability of an MFI to offer savings is very important in targeting poverty, as it has been repeatedly shown that poorer clients are more attracted towards savings, while the better off are more in need of credit. NGOs also face limitations that restrict access to domestic or international capital markets. In some countries where NGOs *have* reached a significant scale, regulators have either come up with a regulatory framework for MFIs separate from banks, such as in Bolivia, or have allowed the sector to flourish unregulated, as in Bangladesh (Montgomery and Weiss 32).

According to much of the literature on microfinance, the biggest drawback faced by non-profit MFIs is that they are inefficient and unable to stand on their own financially. Some observers argue that subsidies have ended up funding inefficient and careless management practices that have resulted in

limited outreach, high loan default rates, and unsustainable operations (Bhatt and Tang 321). Many MFIs claim ‘operational sustainability,’ but in reality the vast majority still require donor subsidies to cover their capital cost.²⁸ In 2004 Drew Tulchin looked at 10,000 MFIs and found that as few as 1-3 percent were both financially self-sufficient and had positive net incomes (Tulchin 10).

Recently, the industry has morphed to include an increasing number of for-profit MFIs, including government-owned development banks, reformed state banks, and commercial banks, in addition to a number of NGOs that have “commercialized” their operations. An increasing number of traditional, non-profit MFIs in the form of NGOs also are changing their legal and organizational structures to more closely resemble those of traditional banks. Usually this is done in an attempt to achieve financial self-sustainability, earn a profit, reach more people, and/or to offer a wider variety of financial services.

These institutions often “scale up” by becoming non-bank financial institutions (NBFI) or a company, which enables them to provide more comprehensive credit products, limited deposits, and achieve regulatory supervision.²⁹ The next stage beyond the NBFI, which has been implemented by

²⁸ For example, between 1985 and 1996 the Grameen Bank reported “profits” of \$1.5 million, but as Jonathan Morduch observed, when modest adjustments are made to standardize Grameen’s accounting practices and philanthropic subsidies on capital are considered, the bank would have actually incurred \$34 million in losses during the same period (Morduch, *The Microfinance Promise* 1590-1591).

²⁹ When institutions transform their operations, they have four basic options to attract the funds necessary for their future growth: donors, public savings, and local and international creditors/investors (Jansson, *Microfinance: From Village to Wall Street* 14).

the “scaling up” of operations for some NGOs such as BancoSol, is the move to become a full-fledged commercial bank, which allows the organization to freely collect deposits from the public (Arvelo, Bell and Novak 131). As a result of the impressive profit margins some of these MFIs are realizing, even financial giants such as JP Morgan, Citigroup, and Deutsch Bank have entered this field that has traditionally been dominated by NGOs.

From a regional perspective, Latin America is leading the way in transforming microfinance from a subsistence activity used to alleviate poverty to a profitable business. Latin America is home to more financially sustainable MFIs than any other part of the world, clearly standing out as the region most driven by profit, and most often diverging from the group lending model. During times of economic slowdown, MFIs in Latin America have held up as well or even better than their counterparts in the commercial banking sector (Jansson and Taborga 6). According to studies carried out by MIX, Latin American MFIs have more assets, use greater leverage, and attract more commercial investments than MFIs in other regions (Callaghan, Gonzalez and Maurice 117). Undoubtedly, the microfinance movement in Latin America is the most commercially-driven in the world.

Microfinance in Latin America has some defining characteristics that distinguish it from microfinance in Asia, Africa, or the transition of Eastern Europe. Most of Latin America’s pioneers began as private, nonprofit institutions, working in urban markets. MFIs have focused on

credit as the primary service offered, only recently beginning to develop savings programs and expand their product lines in such areas as housing and remittances. Although most of the pioneers did target the poor, and low income people still form the majority of microfinance customers, an exclusive focus on the poor is *not* the defining characteristic of Latin American microfinance, as it is for many Asian and African institutions. In Latin America, the emphasis has been on providing services to enterprises with insufficient access to financial services, and to the unbanked in general...Perhaps the most important defining characteristic of Latin American microfinance is the commercial orientation of its leading institutions with respect to operations, financial performance, financing, and ownership, an orientation now catching on in Asia as well. Other key features that define microfinance in Latin America are its adaptability and responsiveness to customer demand, its greater urban concentration, and the diversity of its customers. (Berger, *The Latin American Model of Microfinance* 2, 5)

SELF-EMPLOYMENT AND THE INFORMAL ECONOMY

According to the ILO, “Nothing is more fundamental to poverty reduction than employment...Employment is a key link between economic growth and poverty reduction. Productive and remunerative employment can help ensure that poor people share in the benefits of economic growth” (Karnani, Microfinance Misses its Mark 38). In recent years development practitioners have focused on the shortage of quality jobs and begun to promote entrepreneurship through microcredit as a means of alleviating poverty and fostering development.

The bulk of these microentrepreneurs supported by MFIs operate informally, and especially in Paraguay, many, if not most of these are “own-account workers.”³⁰ While microcredit has been a reasonably effective band-aid for the lack of employment options and financial limitations faced by the self-employed in the informal economy,³¹ it is important to look at the types of jobs that microcredit “creates,” and to understand the characteristics of those jobs.³²

³⁰ The term “own-account worker” is used to indicate the type of entrepreneur that make up a large portion of microfinance clients in developing countries, including those of FP. The ILO defines own-account workers as “those workers who, working on their own account or with one or more partners, hold the type of job defined as a self-employed job, and have not engaged on a continuous basis any employees to work for them during the reference period” (OECD, Glossary). “Workers in the informal economy include both wage workers and own-account workers. Most own-account workers are as insecure and vulnerable as wage workers and move from one situation to the other. Because they lack protection, rights and representation, these workers often remain trapped in poverty” (Chen 6).

³¹ This denotes the portion of the economy that is not taxed or monitored by any form of the government, and usually is not factored into a country’s GDP.

³² Most MFIs make little or no effort to track or encourage the regulation of their clients; several FP credit officials estimated that up to 80 percent or more of their clients work informally.

Martha Alter Chen explained that, “Despite its diversity, the informal economy can be usefully categorized by employment status into two broad groups: the self-employed who run small unregistered enterprises; and wage workers who work in insecure and unprotected jobs (although some, such as homeworkers, don’t fit neatly into either category)” (Chen 1).³³ Multiple analysts have noted that it is useful to think of the informal labor market as being made up of two tiers (Fields et al.), which are comprised of a mixture of the dual classification provided by Chen. In the upper tier, workers choose informal activities because of either the income it provides or because of other aspects such as working hours, access to markets, or being one’s own boss. In the lower tier, workers are enticed by the ease of entry into the informal sector. For these individuals, the informal sector is often a last-resort source of revenue (OECD, Fiscal Policy and Informality et al. 152).³⁴

The countries of Latin America vary considerably in their levels of informality, though in all of them, the size of the informal economy is much higher than in the U.S. Some countries in the region, including Paraguay, are among the most informal economies in the world. The typical country in Latin

³³ “[I]n most developing countries, the largest occupational categories within the informal economy include casual day laborers in agriculture and construction, small farmers, street vendors, domestic workers, workers in small unregistered factories or workshops, and industrial outworkers who work from their homes (aka homeworkers)” (Chen 1) (this description matches the types of microenterprises FP advertises its support for, reported on page 17 of this thesis).

³⁴ The OECD authors used a “crude proxy” for the lower tier by looking at the number of unskilled, self-employed individuals in the informal economy, which suggested that the lower tier is much larger in countries like Bolivia or Paraguay relative to more developed countries like Mexico or Argentina (OECD, Fiscal Policy and Informality 152).

America produces about 40 percent of GDP and employs 70 percent of its labor force informally (Loayza, Servén and Sugawara).³⁵

The informal economy accounts for about 70 percent of Paraguay's measured total GDP, which was the highest proportion found in a study of 32 Latin American and Caribbean countries in the early 2000s (Vuletin 4). Sixty percent of the country's labor supply resides in urban areas (Aguilera 14).³⁶ Overall, informal labor arrangements account for about half of Paraguay's national workforce (Carter, Gacitúa Marió and Silva-Leander vi). In comparison, unregistered labor contracts by private enterprises in the Mercosur area represent 24 percent of total wage labor in Uruguay, 32 percent in Argentina, 38 percent in Brazil, and 68 percent in Paraguay (Tokman 51). In part due to these high levels of informality, tax evasion in Paraguay is estimated at 60 percent; actual GDP figures are believed to be as much as 20 to 50 percent higher than those reported by the Central Bank (Carter, Gacitúa Marió and Silva-Leander V). Outside of agriculture, self-employment makes up the greatest share of informal employment in all developing regions of the world. It represents 70 percent of informal

³⁵ According to Schneider, between 1999 and 2005, underground activities accounted for nearly 16 percent of GDP in the OECD nations and about 35 percent in developing countries (Bose, Capasso and Wurm 2).

³⁶ "As with other indicators, [in Latin America] national averages conceal sharp geographical differences: in rural areas (where own-account and unpaid family workers tend to account for over 50 percent of the employed), vulnerable workers are much more common than in urban areas (where around 30 percent of workers are vulnerable)" (ECLAC 31).

employment in sub-Saharan Africa, 62 percent in North Africa, 60 percent in Latin America, and 59 percent in Asia (Chen 13-14).³⁷

Robyn Davis pointed out that, “In Latin America, and Paraguay especially, informality is generally correlated with illegality, low wages, high labor supply, restricted access to financial markets, limited legal protection, insecure or non-existent property rights, payment of bribes, limited access to public services, absence of labor legislation/protection, and general employment insecurity, among other things” (Davis 1). She is careful to make the point that as a result of the aforementioned problems, the terms “informal” and “microenterprise” sector often indicate the same socio-economic reality.

In Paraguay, home surveys showed that only 13 percent of microentrepreneurs (defined as having 5 or more employees) earned less than the minimum wage. However, of own-account workers, who make up an exceptionally large portion of Paraguay’s “entrepreneurial class,” 61 percent earned less than the minimum salary (Masi 18).³⁸ Paraguay and Bolivia are the only Latin American countries where the poverty rate of employed workers rose substantially between 1990 and 2006 (by about 4 percent) (ECLAC 31). From 1995 to 2004, wages for Paraguayans, including entrepreneurs (multiple employees) and the self-employed, decreased, while hours worked increased (see

³⁷ There is no official data kept on self-employment in Paraguay (Loayza, Servén and Sugawara 11), but it is safe to assume the majority of Paraguay’s self-employed operate informally.

³⁸ Since the self-employed, notably own-account operators, face low earnings and poor working conditions, some argue that own-account workers should be considered to be part of the working class and not the entrepreneurial class (Chen 6).

chart below). It may be that microfinance serves to sustain these low earnings by pushing the strategy of self-employment, and thereby funneling microentrepreneurs, or own-account workers, into an already competitive and saturated labor market among mostly informal vendors and other small enterprise operators.³⁹

*Hourly Wages, hours and labor income
By type of work
In Guaraníes of 2000
Paraguay, 1995-2004*

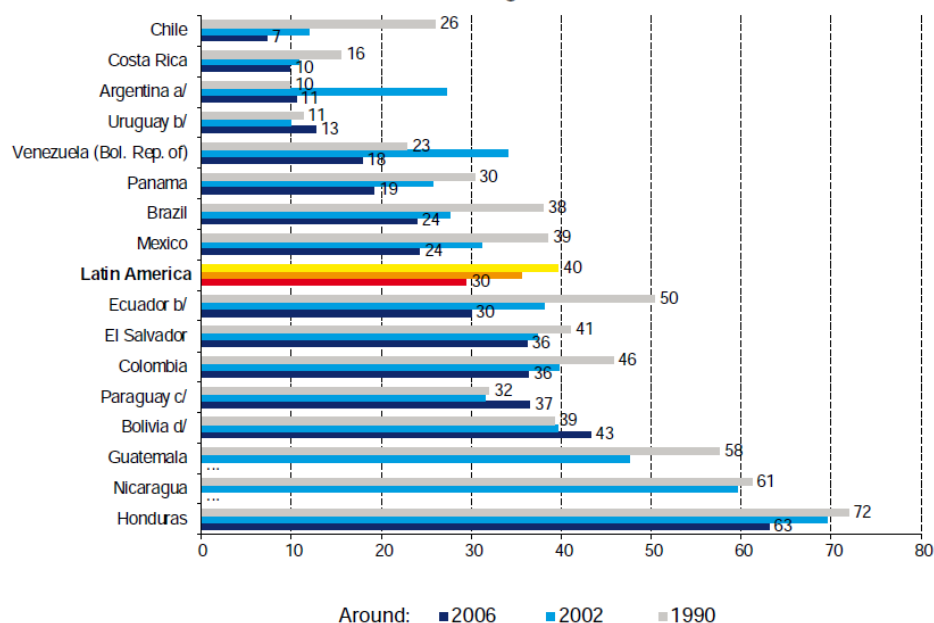
	Wages			Hours of Work				Labor Income		
	Entrepreneurs	Wage earners	Self-employed	Entrepreneurs	Wage earners	Self-employed	Zero Income	Entrepreneurs	Wage earners	Self-employed
	(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)	(ix)	(x)
1995	15,725	4,799	5,103	52.4	48.0	34.2	31.7	3,282,558	883,313	730,822
1997	13,865	5,201	4,703	54.0	48.7	45.7	38.0	2,424,384	937,991	740,065
1999	12,656	5,109	3,915	52.6	47.5	45.4	40.7	2,410,213	887,471	601,833
2001	13,900	4,904	3,042	51.5	48.0	43.6	39.1	2,401,610	841,475	442,315
2002	12,241	4,045	2,764	54.1	50.0	46.6	41.4	2,245,474	730,358	405,157
2003	12,774	4,364	3,489	52.7	49.8	45.0	41.0	2,257,952	793,000	484,907
2004	12,788	3,864	3,618	56.0	50.2	43.4	39.2	2,474,317	703,369	504,299

Source: Own calculations based on microdata from the EH-MO (1995), EIH (1997/98 and 2000/01) and EPH (1999, 2002, 2003 and 2004).

(Fazio and Tornarolli 39)

³⁹ In Bangladesh, where microfinance has flourished, more than 63 percent of the employed population in the capital city of Dhaka operates in the informal sector, which represents a sizeable increase over the last thirty years (UN Habitat 103).

LATIN AMERICA (16 COUNTRIES): POVERTY RATE AMONG THE EMPLOYED, NATIONWIDE TOTALS, AROUND 1990, 2002 AND 2006
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the relevant countries.

a/ Greater Buenos Aires.

b/ Urban areas.

c/ Asunción and the Central Department.

d/ Eight major cities plus El Alto.

(ECLAC 32)

It needs to be noted that not all of those employed in the informal economy, microentrepreneurs or otherwise, would necessarily choose formal employment if given the chance. Especially for women, informal self-employment offers a flexible option that may be preferred due to familial obligations. And just like informal workers, some formal workers live a life of poverty while some do not. Therefore, some informal jobs provide incomes superior to some formal jobs, meaning that voluntary informal employment

certainly exists (Maloney, Self-Employment and Labor Turnover). An important fact that should be considered is that microenterprises operating informally have an unfair advantage over those that operate their businesses legally, paying taxes and adhering to regulatory requirements.⁴⁰

...the intimate association everywhere between microfinance and the rise of the informal sector has unequivocally resulted in the de-legitimation of [the] legal process, undermined respect for the tax system, sanctioned a casual approach towards health and safety and environmental regulations, and has undermined the ability of democratically mandated governments to prohibit sharp business practices. Increasingly, a business either has to travel the 'low road' practices of the rapidly expanding informal sector, or it is forced under. (Bateman and Chang 21)

Entrepreneurial ingenuity?

The philosophy most outspokenly communicated by microfinance proponents is the belief that everyone is an entrepreneur. This conviction is central to the microfinance revolution, and is widely touted by Yunus and others prominent in the microfinance arena, who associate microfinance with “the miracle of markets,” “entrepreneurial spirit,” and the power to “pull oneself up by the bootstraps.” Unfortunately it really does take a special type of person to become a successful entrepreneur. Most people, as evidenced by the very large number of failures among entrepreneurial start-ups, simply do not have the natural talents and traits necessary to reach any measure of considerable success as a

⁴⁰ However, it is important to note that the informal labor environment is unique in every country. In more developed countries like Mexico or Brazil, enterprises may operate unregulated in order to save on things like taxes or labor, while in a country like Paraguay or Bolivia, they operate unregulated because there are too many barriers to formality and there are usually few benefits.

business owner. Necessary personal traits include creativity, risk-taking capacity, common sense, courage, a strong work ethic, energy, and the ability to deal with failure. In developed countries with high levels of education and access to financial services, about 90 percent of the labor force are employees, not entrepreneurs (Karnani, Microfinance Misses its Mark 37). In developing countries, where the conditions for success are not in place, entrepreneurs face even greater challenges.

Dan Gallin notes that

Microenterprise development has been seen by some as a first step to launch own-account home-based workers on a career as capitalist entrepreneurs...these views [are] inspired by neoliberal doctrine without any relationship to what happens in the real world. As the BWA [Bureau for Workers Affairs of the ILO] has pointed out, “for the vast majority of dependent and own-account workers the informal sector is not a stepping stone to improvement but a strategy of survival. (Gallin 542)⁴¹

The progression of informality in Latin America

Within development circles, a lively debate has arisen as to what has driven the entrenchment of informal employment in so many parts of the world. The most common explanations for the phenomenon include:

- Informality could largely be seen as a result of the type of development that fails to generate sufficient good jobs for all. This has been accentuated by

⁴¹ Very few formal sector enterprises start out in the informal sector units (Bateman and Chang 10).

low capacity in the private and public sectors to accommodate rapid population and labor force growth and has been worsened by labor market discrimination and segregation between men and women, social groups and different occupations.

- An increase in subcontracting driven by globalization and economic liberalization has led to greater diversity in the forms of informal employment. This in turn has led to a greater heterogeneity among informal workers, and an increase in the number of those with higher skills and productive capacity.
- Formal regulations have mostly been designed for larger enterprises and are therefore often inadequate for the needs and conditions of the growing sector of micro-enterprises. Changes in labor regulations and/or in implementation of labor regulations may also have had an impact on the share of informality in the economy.
- There has been informalization by employers of once-formal jobs as a strategy to lower labor costs and deal with competition. (Henrik Huitfeldt and Jütting 100)

The growth of microfinance in Latin America, and in other parts of world, has paralleled macroeconomic changes and the institutionalization and growth of the informal economy. Many of these drivers have been shaped in Latin America by a combination of the debt crisis, changes produced during the neoliberal era, and shifts caused by globalization. The ripple effects produced by neoliberal policies in the labor market represented some of the most tangible results of structural adjustments for ordinary citizens. Free market reforms left scores of individuals in the developing world grappling to find meaningful employment, especially in Latin America where the experiment was perhaps implemented in

the most extreme form and with greatest haste.⁴² Millions of displaced Latin American workers were forced to seek refuge in the informal economy, often turning to self-employment, supported by microfinance, as their most viable option.

Neoliberal structural adjustment policies entailed the elimination of subsidies, cutbacks in social services, privatizations, and currency devaluations. Additionally, increased competition with foreign products caused many domestic businesses to fail after they were left to compete in freer markets with imported, often cheaper, products.⁴³ In not just Latin American but in multiple parts of the world, these types of changes resulted in immense increases in unemployment and underemployment, leading to greatly increased competition for jobs as millions of former state employees and other displaced workers were abruptly forced into the labor market to compete for gainful employment. With the added pressures of globalization, these changes also perpetuated migration from rural to urban areas, further increasing the labor supply. Since growth in formal private employment did not compensate for these lost jobs, this “forced former employees to create

⁴² In the 1980s, the IMF and World Bank gave an average of five adjustment loans to each country in Latin America (Easterly, *The Elusive Quest* 102). During the decade, the use of the term “informal sector” became popular, as the economic crisis in Latin America highlighted the fact that employment in the informal sector tends to grow during periods of economic crisis (Chen 4).

⁴³ Competition with imports, especially when introduced at a rapid pace, creates significant transformations throughout the respective industries; profit margins could increase in some cases, diminish slightly, or other times entirely vanish. “Firms respond by shifting resources toward industries in which profitability has risen and away from those in which it has fallen” (Phillip and Slaughter 5). This causes more workers to be needed in newly profitable sectors and fewer in less profitable sectors (Phillip and Slaughter 5). As a result, demand for labor with certain skills may have fallen, even as labor shortages may have existed in other industries.

their own economic solutions through petty enterprise,” which was a form of economic adaptation that became the major source of employment creation in Latin America (Portes and Hoffman et al. 48).

In Latin America in the 1990s, 70 percent of the jobs created were in the informal sector (United Nations: ECLAC and UNEP 48).⁴⁴ Some have contended that the informal sector has more than doubled in Latin America since the 1980s (Bateman and Chang 13). Emilio Klein and Victor Tokman found that in Latin America, microenterprises accounted for 100 percent of all new urban jobs in 1998, and of every 100 new urban jobs created between 1990 and 1998, 30 were created in small enterprises and another 29 were in self-employment (Hoffman and Portes 48).⁴⁵

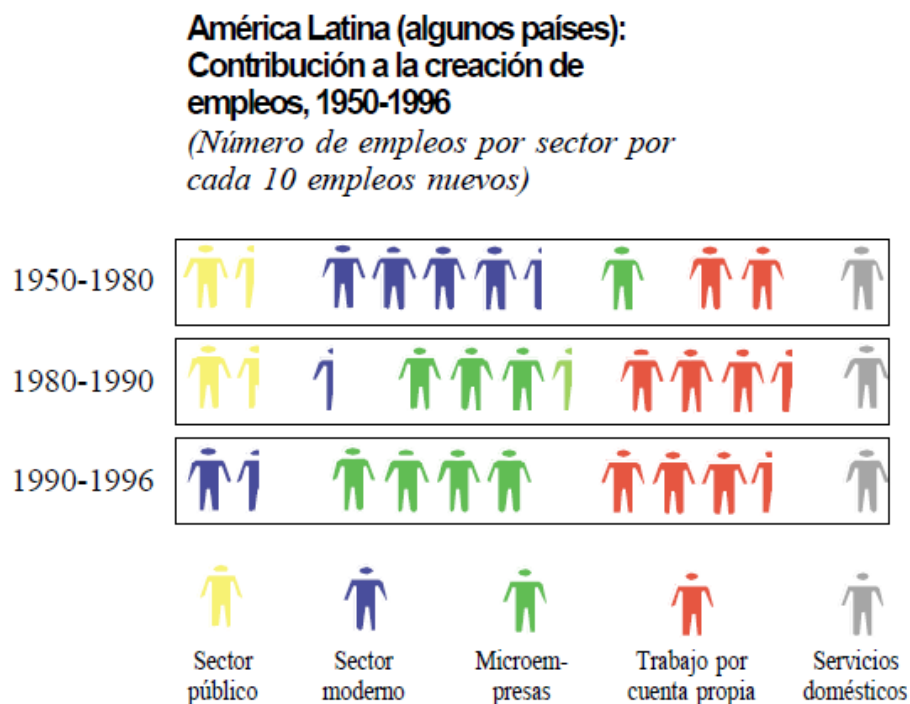
Hence, in an effort to satisfy the increased demand for small lines of credit produced by these changes, the microfinance revolution was born, catering to what could be referred to as “forced entrepreneurs.” Microfinance has flourished as a response to these structural changes in the labor market, also assisted by a decrease in money supply.⁴⁶ NGOs, development organizations, and commercial

⁴⁴ Timothy Nourse puts the figure at 84 percent of new jobs, which accounted for 54 percent of all employment opportunities (Nourse 61).

⁴⁵ These proportions are substantially higher than those during ISI periods. Between 1950 and 1980, 60 percent of all new employment was created in the formal sector, with government accounting for 15 percent and modern large and medium enterprises contributing the remaining 45 percent (Hoffman and Portes 49).

⁴⁶ In comparison with the earlier era of ISI, “the present era registers a visible increase in income inequality, a persistent concentration of wealth in the top decile of the population, a rapid expansion of the class of micro-entrepreneurs, and a stagnation or increase of the informal proletariat” (Hoffman and Portes 1). Portes and Hoffman believe that the rise of informal self-

banks recognized the increased demand for microenterprise credit and stepped in to meet it, sparking an explosion in what was once a small scale, grassroots poverty alleviation strategy.⁴⁷ It is no coincidence that microfinance really began to take off in Latin America at the culmination of this period, as many of Latin America's MFIs began with an expressed intention to support microenterprise.



(Klein and Tokman 12)

employment and micro-entrepreneurialism throughout Latin America can be interpreted as a direct result of neoliberal adjustment policies (Hoffman and Portes 41).

⁴⁷ Marconi and Mosley have noted that in Bolivia, microfinance realized spectacular growth, as displaced workers were pushed into "...self-employment, in which function they found themselves strongly supported by several donors (especially USAID and IDB) and by a centre-right government which saw microfinance as a particularly appropriate technique for 'mitigating the social cost of adjustment.'" (Marconi and Mosley 238)

TABLA II. América Latina: Evolución del Empleo Urbano

Años	SECTOR INFORMAL				SECTOR FORMAL		
	Total	Cuentapropistas	Serv. doméstico	Microempresas	Total	Sector Público	Empresas Medianas y Grandes
1990	51,6	24,7	6,7	20,2	48,4	15,3	33,0
1991	52,4	25,0	6,7	20,7	47,6	15,2	32,5
1992	53,0	25,6	6,7	20,8	47,0	14,6	32,3
1993	53,9	25,3	7,1	21,6	46,1	13,7	32,4
1994	54,9	25,8	7,0	22,1	45,1	13,3	31,8
1995	56,1	26,5	7,1	22,5	43,9	13,2	30,8
1996	57,4	27,2	7,1	23,1	42,6	13,0	29,6
1997	57,7	27,1	7,6	23,0	42,3	13,0	29,3

Fuente: OIT.

(Masi 6)

Causes of informality in Paraguay

Masi has pointed out that the reasons for the increase in activity in the informal economy are distinct in Paraguay. Unlike other countries in the region, this phenomenon is not directly tied to structural adjustments reforms, or the modernization of the industrial sector. Instead, the increase in informality is mainly related to internal migration and economic hardships (Masi 1, 12). He has argued that in Paraguay, unlike most other countries in Latin America, the causes for deteriorating employment and the rise of informal employment are not found in the diminution of the state nor in the process of accelerated industrialization. Rather, he attributes it to the deterioration of income levels in the rural sector and the dynamism in import and re-exportation activity (Masi).

The growth of the labor supply that occurred in urban areas, fueled by migration, could not be absorbed by the economy that was based in agriculture and re-exportation. This led to growing levels of underemployment and informal employment (Masi 12). As highlighted by home surveys conducted by the government, a decrease in employment opportunities led to a deterioration of living conditions in the late 1990s in Paraguay. Underemployment was the principle source of job creation in the 1990s, in the form of own-account workers, domestic service, and microenterprise, which decreased salaries and increased inequality. This deterioration of employment conditions coincided with the absence of reforms and economic stagnation and recession (Masi).

Paraguay is consistently ranked among the most corrupt countries in the world, so it is important to note that levels of corruption are closely correlated with the size of the informal economy.⁴⁸ Friedrich Schneider and Dominik Enste recounted that, “Corruption is sometimes involved in: satisfying regulations and obtaining licenses to engage in particular activities (opening a shop, operating taxi), land zoning and similar official decisions, access to publicly provided goods and services, decisions regarding procurement or public investment contracts,

⁴⁸ In an empirical investigation of forty-nine countries, Simon Johnson, Daniel Kaufmann, and Pablo Zoido-Lobaton found a statistically significant relationship between the various measures of bribery and corruption and the informal economy. “In summary, the relationship between the share of the unofficial economy and rule of law (including corruption) is strong and consistent across eight measures provided by six distinct organizations. All eight of the indices suggest that countries with more corruption have a higher share of the unofficial economy” (Schneider and Enste 27).

control over the provision of tax incentives, and hiring and promotion within the public sector” (Schneider and Enste 90).

While in some ways the causes of the entrenched nature of the informal economy may be different in Paraguay than in other Latin American countries, the informal sector shares similar characteristics such as relative insecurity and uncertainty of employment, low salary levels, and being the major source of employment in urban areas (Masi 1). Masi has stated that “the majority of informal workers in Paraguay are non-professional, self-employed workers and employees of micro-enterprises [who are] involved in commercial and service activities, are located in the most densely populated urban areas, have a primary education [and earn] salaries equal to or less than the minimum wage” (Masi 1).⁴⁹ Since the rise of this sector in the 1980s, it has taken on a “fundamental role” in Paraguay’s economy, and has particular relevance for microentrepreneurship and women in the labor force (Robles 129).⁵⁰

Paraguay’s regulatory problems

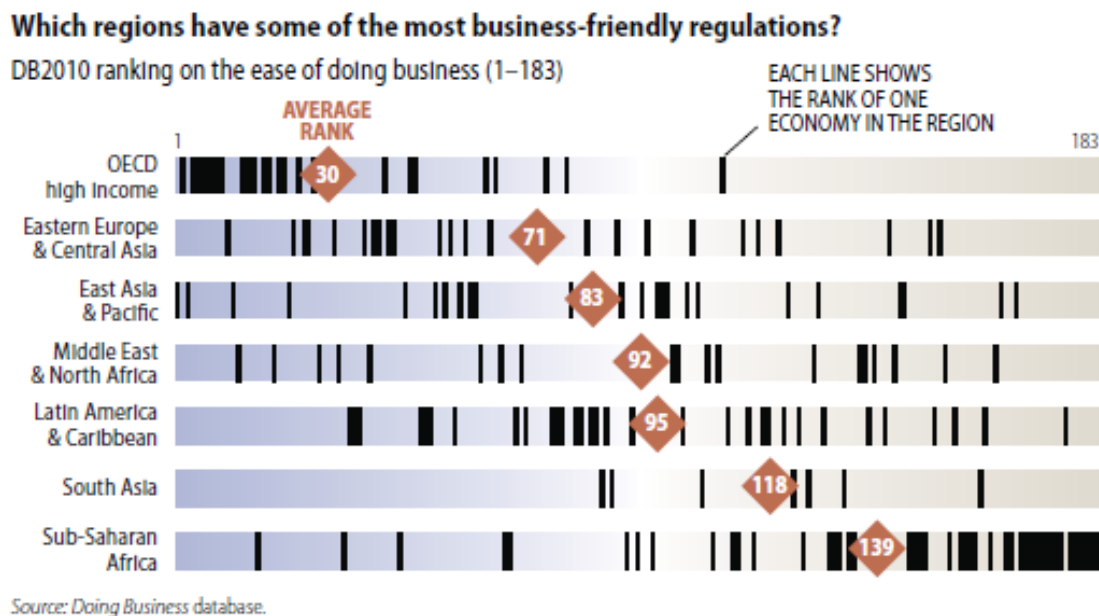
Paraguay is a country with numerous, significant obstacles to overcome if it is to set itself on a path towards prosperity.⁵¹ If microfinance is to play a part, the tools for success must be put in place. In the World Bank’s 2010 “Doing

⁴⁹ Translation by Heter (2008), pg. 24.

⁵⁰ Translation by Heter (2008), pgs. 23-24.

⁵¹ As of 2008 Paraguay was one of the Latin American countries furthest from achieving the first MDG, to eradicate extreme poverty and hunger, along with Guatemala, Honduras, and Bolivia (ECLAC 14-15).

Business” report, an annual series of reports that investigates the regulations that enhance business activity and those that constrain it, Paraguay is ranked 124th out of 183 countries in ease of doing business (Doing Business 4).⁵² In addition to the problems informally employed individuals face, Paraguay’s extremely high levels of informality undermine the domestic business environment, weakening any hope for significant economic development. Informality has a statistically and economically significant negative impact on growth and an equally significant positive impact on the incidence of poverty across countries (Loayza, Servén and Sugawara 14).



(Doing Business 1)

⁵² Bolivia, home to one of the world’s most active microfinance environments, is a country characterized by similar levels of both informality and development. The report ranks it 158th (Doing Business).

In Paraguay, as in other developing countries, the lack of judicial protection accorded by informal status is not only tied to vulnerability, but for microenterprises also restricts access to the legal system in important areas like contract enforcement. This is an area that poses significant obstacles in developing countries, for both formal and informal firms. Deficient legal systems greatly hinder cooperation between microenterprises, stunting their growth. When businesses avoid entering into contracts due to a perceived, and in many cases, serious lack of enforcement, it has a significant impact on a country's business environment, with great detriment to the economy.

One drawback is the fact that microentrepreneurs that produce value-added goods are limited in their ability to negotiate contracts with companies that may want to utilize their services. Informal entrepreneurs also are limited in their ability to sign contracts with suppliers they buy from, which could offer them discounted rates and improved payment options. Furthermore, the lacking regulatory environment makes it difficult for small business owners to employ others, as potential employees may avoid certain offers due to the fact that there is little or no legal recourse for unfair treatment or wages.

These are the types of problems that Hernando De Soto has emphasized, which has garnered him Nobel attention. He is especially concerned by the fact that dubious property rights laws cause people to be undercapitalized (De Soto,

The Mystery of Capital),⁵³ which is a problem that poses major difficulties for both formal and informal enterprises in developing countries. He has argued the importance for developing countries to construct a legal system that protects individual property rights, enforces contracts, to devise a system to define and records deeds, patents, and copyrights, and to establish a rule of law and system of civil courts. Together, these changes will bring out the value in dormant saving and latent intellectual potential in developing countries (Kemp np). “When property law works, the capital value of assets rises in developing nations” (De Soto, *Law and Property Outside the West* 350). De Soto also notes that establishing a functioning property law regime would bring the underground economy to the surface. With these systems properly in place, the effectiveness of microfinance would soar.

As in many developing countries, in Paraguay, the deficient, disadvantageous regulatory environment and legal regime, which leads to and is exacerbated by high levels of informality, may be one of the strongest obstacles keeping microfinance from reaching its full development potential. With little or no avenue for legal recourse, it is difficult for businesses to operate at optimal efficiency, and negative spillover effects reverberate throughout the economy.

⁵³ For example, “The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur’s house. These assets can also provide a link to the owner’s credit history, an accountable address for the collection of debt and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in the secondary markets” (De Soto, *Law and Property Outside the West* 350-351).

The insufficient legal and regulatory environment in Paraguay severely constricts microenterprise development, and does little to provide the tools necessary for entrepreneurial success.

Personal observations and conclusion

The entropy of Paraguay's highly informal, highly competitive economy is unmistakable in many of its urban areas. In parts of Asunción and outlying areas, and especially in Ciudad del Este, the bustling informal market is more than evident; it actually jumps out at you, sometimes in the form of shouting street vendors selling miscellaneous items, and even attractive young women employed by shops to entice or even literally drag passing men into their stores. In heavily occupied market areas it is actually necessary to step off the sidewalk to get around the perfunctorily placed, overcrowded spaces occupied by microenterprises. Particularly in Ciudad del Este, it is nearly impossible to avoid the deluge of informal microentrepreneurs hawking their wares to all passer-bys. These microenterprises, which sometimes may consist of no more than an "entrepreneur" with a box of assorted goods, sell anything from fruit, candy, and gum, to cell phones and pirated DVDs.

Even on the buses in Asunción, informal "entrepreneurs," or own-account workers, who are often young, sometimes unaccompanied children, sell trinkets and small food items from makeshift displays. In the stands on the streets,

entrepreneurs commonly sell (often contraband) clothing and other goods like shoes or cell phones and electronics. Frequently, identical goods can be found at neighboring stands throughout the area, or many times at the very next stand. Typically these vendors pay a modest monthly fee to rent their space, but other times makeshift stands can be found in seemingly desultory locations. There are also owners and employees of medium-sized enterprises, which usually occupy permanent physical spaces, who shop these bustling, microenterprise-lined streets in order to find good buys on items like clothing. They then resell the clothing in their own shops in more exclusive parts of town, at significantly higher prices. According to an employee of a trendy clothing store in an affluent area of Asunción, these markups can be more than 500 percent.

One of the more troubling characteristics of Paraguay's economy is the fact that many of the products sold by these microenterprises are regularly smuggled from Argentina and Brazil through Ciudad del Este, one of the world's most heavily trafficked points of entry for smuggled goods.⁵⁴ This does little to support Paraguayan industry (small as it may be), and not only is the government missing out on much needed tax revenues that are circumvented by the informal nature of these businesses, but it also misses out on import duties.

After visiting these businesses and speaking with entrepreneurs that utilize microfinance, it seems that most of them can be categorized as own-account

⁵⁴ As of early 2000 it was estimated that Ciudad del Este made up about 73 percent of Paraguay's border trade (Braumann, Jaramillo and Jenkner 20).

workers, who occupy the “lower tier” of informal work. For them, self-employment is not a path out of poverty and into economic success, but a coping mechanism. The words of FP’s credit officials in the San Lorenzo office illustrate this claim; when asked why their clients are self-employed, and need microcredit, the almost uniform response is that they are trying to “*sobrevivir*,” or survive.

These microfinance clients participate in saturated, extremely competitive labor and product markets, and many would work elsewhere if the opportunity existed (which, if it did, would decrease competition, allowing those remaining in the market to grow and become more profitable). Perhaps most obvious is that microfinance alone, even when tied with programs like business training and health initiatives, is not enough to significantly improve this situation. Substantial regulatory reforms are needed, offering less burdensome paths to formality and improved access to the legal system, which is in crucial need of improvement. This would decrease the precarious nature of informal self-employment by allowing microentrepreneurs to utilize social services, and promote inter-firm cooperation by increasing the incentive to enter into contracts. However, the quality and quantity of those social services also need to be improved, and corruption must be greatly reduced. These are lofty goals, but are absolutely critical if development is to be set in motion and if microfinance is to reach its full potential in the process.

THE MICROFINANCE MARVEL

Introduction

Microcredit can offer a legitimate solution to poverty for millions of people. Access to financial services is an important ingredient for economic development in the modern global economy, and can be especially fruitful within a sound macroeconomic climate. Worldwide success stories of individuals and families propelled from poverty by microcredit are impossible to ignore, especially when the story is that of a woman in a male-dominated society.

For many, especially in developing countries, self-employment is one of few practical solutions to lack of opportunity and the resulting poverty. This truth, which is repackaged and sold as entrepreneurial spirit and the miracle of markets, has helped to spread billions of dollars worldwide through a thriving microfinance market. Microcredit can be provided to entrepreneurs in some of the poorest and most remote areas of the world, funneled through the world's largest governments, development organizations, banks, corporations, groups of entrepreneurs themselves, or even individual lenders across the world using internet sites like Kiva or Microplace.

One of the strongest reasons that microcredit and thereby microfinance has achieved such a strong backing is that it is not a handout; microcredit is a philosophy of self-empowerment. Attractively, microfinance is about local processes, and until recently as a result of its growth and the advent of

commercialization, was a grassroots strategy that involved no large corporations or intervention from hegemonic powers.

While microfinance has taken off and realized phenomenal growth, touted for its social and economic development capabilities, aside from its apparent effectiveness on an individual scale, the strategy of providing financial services, and especially promoting self-employment, has yet to be demonstrated to be an effective instrument for progress on an aggregate level. Some even allege that microfinance constrains true development.⁵⁵ Even in countries like Bangladesh and Bolivia where the microfinance movement is among the strongest in the world, noteworthy national indicators of development, such as the HDI, GDP per capita, and the GINI index, remain exceptionally low. Where improvements in some areas have been made, a credible link to microfinance has not been clearly established.

Meanwhile, countries such as China, Vietnam, and South Korea have experienced very substantial improvements in wellbeing in the absence of a strong microfinance presence (Karnani, *Microfinance Misses its Mark* 37). Economists agree that throughout world history, most significant progress in terms of development was inculcated through state intervention and large investments. Though the top-down, state-led paradigm has failed developing

⁵⁵ In a 2008 letter to the Financial Times, for example, Milford Bateman wrote, “In nearly 25 years of academic and consulting work in local economic development, my experience is that microfinance programmes most often spell the death of the local economy” (Bateman, *Microfinance's 'iron law'*--local economies reduced to poverty np).

countries on multiple levels, never before has a nation achieved noteworthy measures of successful development through the proliferation of microenterprise. Therefore, numerous questions remain unanswered about microfinance and its ability to pull populations out of poverty.

The impecunious traditionally have not had the option to take out a loan or utilize the services of a bank for savings, and while it is surely a good thing that microfinance has relieved this absence of financial services, and a sound financial sector is necessary for development, there has been too much focus on this particular strategy. The microfinance movement is expanding extremely rapidly, perhaps even to the point of leaving room for exploitation and constricting significant progress on a wider scale. Perplexingly, not everything about microfinance is as clear-cut and salubrious as it has been reported to the common observer.

After spending time in Paraguay with FP, it was not evident that microfinance and other services offered by the foundation, such as business training, were effectively enabling people to escape poverty. While impressive programs optimizing synergies between education, training, and credit were emphasized by the foundation, it appeared that the majority of clients were simply using their loans to sustain their lifestyles, which appeared to be characterized by lack of opportunity and unpredictable earnings in extremely competitive, saturated labor and product markets. Most of those in the middle class were there

because they began there, not because a small loan propelled them there. Additionally, many of the microentrepreneurs work long days, sometimes 12 to 17 hours, and some hold multiple occupations.

Furthermore, many clients of FP engage in extremely inefficient business practices, including making multiple trips to suppliers throughout the week to purchase small amounts of inventory at a time. Practices such as these should not be necessary since the credit is meant for business expenses, to supply entrepreneurs with the capital to expand and to purchase in bulk, thus saving time and possibly providing a reduction in cost. Additionally, many clients simply worked in microenterprises that were equally marginal, and often completely indistinguishable from the thousands of other microenterprises in the country, even those directly alongside them.⁵⁶ Furthermore, in many of the microenterprises such as those selling clothing or fruits and vegetables, the majority of items were imported, sometimes illegally.

Clearly, microfinance is a small part of the equation for progress in Paraguay, as in every other developing country in the world. At this point in time, it serves more as a coping mechanism for those shut out of the formal labor and credit markets. Doubts about the impact of microfinance on individuals and on the overall economy were cultivated by witnessing microfinance operations firsthand and further substantiated by the small, yet growing body of literature questioning the short and long-term prospects of microfinance. For microfinance

⁵⁶ This led to a running joke among the FP interns that clients were employed in “copycat retail.”

to reach its potential and for real progress to occur, many other measures must be provided, many of which can only be offered by the state.

With all the sensationalism surrounding the global MFI movement, the impression may be left that financial services for the poor are the cure-all for poverty. Today nearly every major development organization participates in some aspect of microfinance. The first part of this chapter will look at some of the remarkable triumphs that microfinance is said to have brought to the world's poor, and includes a compendious survey of a few prominent studies that highlight these benefits. In the second section of this chapter, some possible drawbacks and uncertainties related to the microfinance movement will be discussed. The intention is to pose some questions about the potential for the effectiveness of microfinance in the long run, not just as a poverty alleviation tool for individuals but as part of a strategy that can place populations on the path to long term social and economic progress. The overarching effort is to restore expectations to more realistic levels.

Access to credit

In many parts of the world, the simple fact that the poor even have the option to utilize financial services traditionally reserved for the rich and well-connected is revolutionary. It is well-known that an effective financial system is necessary for a country to reach and sustain high levels of economic growth. The

Global Director of Microfinance for Citigroup, Robert Annibale, estimated that 2.5 billion people, or 40 percent of the world's population, have never used a bank or formal credit institution (Smith and Thurman 40). A CGAP survey found that various institutions targeting clients with an unmet demand for financial services included 750 million accounts, which translates into 500 million clients at most, comprising only a fraction of the world's 3 billion or so poor people (Helms 6).⁵⁷

According to CGAP, the microfinance industry is in the range of \$30 billion, and expanded lending 40 to 50 percent annually from 2004 to 2009 (Copeland A12). A 2007 report by McKinsey and Co. estimated that worldwide loan portfolios of MFIs have the potential to grow to \$250-300 billion within the next couple of decades (Callaghan, Gonzalez and Maurice 118), and some experts have estimated that only about 10 percent of the world's total demand for microfinance is being met (Hechler-Fayd'herbe 2).⁵⁸

⁵⁷ Ricardo Bebczuk of the IDB stated that "Limited financial inclusion does not simply follows [sic] from unfair discrimination against the poor, but to a great deal from a low demand for financial services and scarce access for the population at large" (Bebczuk 1).

⁵⁸ Again, it should be noted that these figures are highly contested. It has been widely assumed that just because the poor have no access to financial services, there is necessarily a demand (Dichter et al.).

Coverage of the Potential Market by Country¹²

Country	Estimated size of the market (1)	Market being covered 2004 (2)	(%) Coverage
Bolivia	681,160	379,713	55.7%
Chile	603,590	168,799	28.0%
El Salvador	333,590	89,427	26.8%
Paraguay	493,660	82,658	16.7%
Peru	3,433,095	899,196	26.2%
Colombia	3,250,900	442,109	13.6%
Mexico	5,136,950	347,874	6.8%
Dom. Republic	696,090	70,602	10.1%
Honduras	445,590	17,356	3.9%
Venezuela	1,623,635	13,368	0.8%
Guatemala	710,855	42,491	6.0%
Total	17,409,115	2,553,593	14.7%

1. Westley 2001

2. Study by the authors, ACCION International, MixMarket, CGAP, IMI

(Marulanda and Otero 14)

Across the world, the demand for credit and especially savings is particularly high in rural areas, which banks typically avoid. One of the greatest challenges for microfinance, and a source of great potential, is to reach these rural areas where the majority of the poor live in Asia and Africa, and where the majority of the extreme poor live in Latin America. Servicing microfinance clients in rural areas is much more expensive and far more difficult than in urban areas. Transaction costs are much higher especially due to transportation difficulties and lower population densities that make it difficult to reach any level

of economies of scale. The financial sustainability of rural microfinance is uncertain, and represents a major challenge for the future of microfinance (Callaghan, Gonzalez and Maurice et al. 118). However, the fact remains that, in every population, rural communities are the most underserved by financial services.

FP does have a rural microfinance program, but it is small and is faced with many obstacles, even though in many areas there is no competition. The challenges mainly involve the distance of the customers to the offices, which makes payment collection and distribution of loans difficult. The entire program consists of only one credit official, stationed in the main office in Asunción, servicing about 300 clients (as of the summer of 2008). This necessitates overnight trips to rural areas to meet with borrowers. Payment is often collected by local contacts, not official FP employees. Operations for the rural program are sustained by funds accrued through the individual lending program and from the support of the IDB.

Female empowerment

Of the 1.2 billion people in the world that live on less than \$1 a day, 900 million of them are female (Smith and Thurman 122). Microfinance has shown an exceptional ability to combat female poverty, which represents what is probably the greatest boon tied to microfinance. Especially in cultures where

women are uniformly repressed, self-employment fueled by microcredit offers what is often the only outlet from a life of subjugation. The 2006 Nobel Committee commented that “Microcredit has proved to be an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions. Economic growth and political democracy cannot achieve their full potential unless the female half of humanity participates on an equal footing with the male.”

For women, self-employment can be an extremely useful method to improve their own situation and that of their family. Due to the flexibility offered by self-employment, women are able to continue to care for their families and supplement family income while still being able to complete household chores, which can be far more onerous and obligatory than those in the developed world. Tales of women receiving small loans and improving their own lives and the lives of their children are widely disseminated in the media and marketing campaigns of MFIs. These women are the poster children of the movement.

It has been reported that access to microcredit and other financial services has led to benefits including improvements in familial nutrition and health and increases in education. In addition, most observers consider note that the participation of rural women in microcredit programs helps to reduce the fertility rate. Md. Abul Basher has even suggested that Grameen Bank weakens parental preferences for male children (Basher 172, 182).

As a result of microfinance participation, a woman gains more control over her life by taking part in the management of family resources. After putting small loans and other services offered by MFIs to use, many women report greatly improved self-esteem and feeling a sense of purpose, sometimes for the first time in their lives. In addition, there have been highly publicized anecdotal reports of women who suffered years of beatings from their husbands and report that the violence decreases or even ends after taking out a microloan to become self-employed. Furthermore, group lending systems have commonly been reported to forge community bonds or strengthen those that already exist.

Academic literature has established that women tend to spend larger portions of their income than men on familial needs such as housing, health, and education, which is one of the main reasons MFIs with social goals focus on women. In addition, women more often lack access to financial services and some consider them to be more responsible than men at repaying debt. A New York Times article pointed out the advantages of increasing women's incomes by looking at a research project that examined the different crops that men and women cultivate in the Ivory Coast. There, men grow coffee, cocoa, and pineapples, while women grow plantains, bananas, coconuts and vegetables. In her investigation, economist Esther Duflo of MIT found that when the men's crops flourish, the households spent more money on alcohol and tobacco. On the other hand, when the women had a good crop, the households spent more money on food (Kristof and WuDunn 4).

As a result of the aforementioned benefits, microfinance is probably the most valuable means devised to date for improving gender relations in developing countries. Anecdotal accounts of empowerment against repression are the clearest demonstrations of the potential of microfinance, and it is these types of success stories that provided the spark that drove the movement to where it is today.⁵⁹ It should be noted there is a vast range in the type of microfinance services offered, from the ‘minimalist’ credit-only approach to the type that offers various social services and try to influence cultural change. For example, Grameen’s Sixteen Decisions, which is recited by its group members at the start of every meeting, is meant to influence lives for the better in a number of categories, reaching far outside the financial realm.

⁵⁹ On the other hand, there have also been widespread reports of women being publicly “shamed” for not paying their loans, in addition to reports of women taking out loans because their husbands are unable to, then having no say in how the credit is used. In other cases increases in domestic violence have actually been linked to microfinance participation (Hashemi, Schuler and Riley).

Grameen's Sixteen Decisions

1. We shall follow and advance the four principles of the Grameen Bank-discipline, unity, courage, and hard work-in all walks of our lives
2. Prosperity we shall bring to our families
3. We shall not live in a dilapidated house. We shall repair our houses and work toward constructing new houses at the earliest opportunity.
4. We shall grow vegetables all the year round. We shall eat plenty of them and sell the surplus.
5. During the plantation seasons, we shall plant as many seedlings as possible.
6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.
7. We shall educate our children and ensure that they can earn to pay for their education.
8. We shall always keep our children and the environment clean.
9. We shall build and use pit latrines.
10. We shall drink water from tube wells. If they are not available, we shall boil water or use alum to purify it.
11. We shall not take any dowry at our sons' weddings; neither shall we give any dowry at our daughter's wedding. We shall keep the center free from the curse of dowry. We shall not practice child marriage.
12. We shall not commit any injustice, and we will oppose anyone who tries to do so.
13. We shall collectively undertake larger investments for higher incomes.
14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help him or her.
15. If we come to know of any breach of discipline in any center, we shall all go there and help restore discipline.
16. We shall introduce physical exercises in all our centers. We shall take part in all social activities collectively. (Yunus, Creating a World Without Poverty 58-59)

High expectations

Much of the euphoria surrounding microfinance comes from the academic literature that has established that microfinance can have tremendously positive effects on people's lives.⁶⁰ These almost universally positive findings have been reproduced through numerous academic works. In order to get a sense of the portfolio of benefits attributed to microfinance, and what has created such sensationalism, a highlight of some of the more widely disseminated studies follows:⁶¹

-An early 1988 study found that Grameen members had incomes that were 43 percent higher than incomes of control groups in non-program villages and 28 percent higher than non-members in Grameen villages. Wage rates throughout program villages also reportedly increased (Hossain).

-In one of the most widely cited (especially by Yunus) studies, an assessment in the early 1990s focused on Grameen, the Bangladesh Rural Advancement Committee (BRAC), and RD-12, concluding that the women who were clients of these institutions increased household consumption by 18 *takas* for every 100 borrowed, and that 5 percent of clients escaped poverty each year. Spillover effects throughout the local village economy among non-members were also reported, including an increase in village wage rates (S. R. Khandker, *Fighting Poverty with Microcredit*).

-A BRAC study found that basic competency in reading, writing, and arithmetic among children 11-14 years old in member households increased from 12 percent at the start of the program in 1992 to 24 percent in 1995 (only 14 percent of children of non-member households passed the competency tests in 1995) (Bhuiya and Chowdhury).

⁶⁰ It should be noted that much of the early research was limited to a few countries, with the results often cited in support of replicating identical programs elsewhere.

⁶¹ Many of these studies were cited by Hashemi, Littlefield, and Morduch as examples of how microfinance can help to achieve the MDGs. The authors did note that a few studies failed to find positive impacts from microfinance, or in rare cases discovered a negative impact, but "the frequency of such outcomes has been too low to cast much doubt on the generally favorable conclusion indicated by the bulk of the evidence" (Hashemi, Littlefield and Morduch 2).

-In 1996 it was found that Grameen and BRAC participants with continued access to loans had lower rates of poverty than those without access, 57 percent compared to 76 percent (Khandker and Chowdhury).

-A 1996 impact assessment of BRAC suggested that members who stayed in the program for more than four years increased household expenses by 28 percent and assets by 112 percent (Mustafa, Ara and Banu).

-A 1996 survey of clients and non-clients in Bangladesh concluded that recipients of microcredit were significantly more empowered than non-clients in regards to their physical mobility, ownership and control of productive assets, involvement in decision making, and political and legal awareness. This empowerment increased with the duration of the member (Hashemi, Schuler and Riley).⁶²

-A 1999 examination of CRECER in Bolivia, which provides basic health education in addition to financial services, found that clients had better breast-feeding practices, were more likely to give rehydration therapy to children with diarrhea, and had higher rates of DPT immunization for their children (Dunford and MckNelly).

-In 2001 a Peruvian study showed that clients of MFIs earned \$266 more per household member each year than non-clients (Arbuckle Jr. and Dunn).

-In 2001 in Bolivia the cost of lifting a person out of poverty and out of extreme poverty through microfinance was calculated, in comparison to initiatives such as primary health, primary education, and rural road building. Depending on the MFI, the average cost of moving an individual above the poverty line was between \$300 and \$600, which was cheaper than other alternatives examined, aside perhaps from rural health expenditures (Mosley).⁶³

-A 2003 investigation in Bangladesh showed that a 10 percent increase in credit to women was associated with a 6.3 percent increase in mid-arm circumference of daughters. There also was a statistically significant positive effect on height for boys and girls (Chowdhury, Khandker and Millimet).

-A widely cited 2005 study of Bangladeshi microfinance participants found that members that had been participants for six consecutive years saw their poverty rates decline by more than 20 percent. It was estimated that more than half of this

⁶² It was also found that in some cases increases in domestic violence were linked to microfinance participation, though over time families became more accepting and violence decreased (Hashemi, Schuler and Riley).

⁶³ Although it was concluded that microfinance was not an effective means for reducing *extreme* poverty. In the investigation with a sample of nearly 200, over six years, only one case was found in which an MFI had managed to reduce extreme poverty, and it was in an indirect manner through the labor market (Mosley 129).

reduction could be directly attributed to microfinance, and that microfinance accounted for 40 percent of the entire reduction of moderate poverty in rural Bangladesh (S. R. Khandker, Microfinance and Poverty).

The Peace Corps supports microfinance for the following reasons:

- Most of the goods and services needed to meet people's basic needs in developing and redeveloping countries are provided by microenterprises.
- Often microenterprises are the only economic organizations that function in times of crisis.
- Microenterprises require small amounts of capital to enter the market and produce results quickly.
- The small size of microenterprises makes them simple to operate.
- Microenterprises use local products and skills.
- Microenterprises are labor intensive and create jobs.
- Microenterprises improve the income of the entrepreneurial poor.
- Microenterprises are a catalyst for comprehensive community economic Development. (Peace Corps 1)

Emerging Criticism

For years, criticism of microfinance was almost absent, and the benefits reported to be associated with microfinance went almost universally unquestioned. When criticism towards microfinance had been leveled, it was mostly met with denunciations (found in multiple microfinance blogs, comment forums, and public responses to articles such as those written by Dichter or Bateman). Dichter has written that, due to a lack of reliable evidence, “anyone can say almost anything, and with the public relations surrounding the field, much of it goes unquestioned” (Dichter and Harper, What's Wrong with Microfinance?

5). Especially as of the summer of 2009, critics have begun to come out of the woodwork, and earlier brazen promises of potential are being reexamined.

In a surprising turn of events, Jonathan Morduch, a longtime microfinance advocate who has authored widely read textbooks and publications on the subject, admitted that, while economic theory suggests microfinance has benefits, “[r]igorous evidence that shows it happening just doesn’t exist ... The evidence is pretty dicey” (Bateman and Chang 5). Morduch wrote that, “strikingly, 30 years into the microfinance movement we have little solid evidence that it improves the lives of clients in measurable ways” (Morduch and Roodman 4). He also conceded that microfinance “rarely generates new jobs for others” (Surowiecki np). Even Elizabeth Littlefield, a World Bank director and the CEO of CGAP, has recognized that “there is no statistical evidence to support the idea that microfinance has a significant impact on poverty reduction on a global, or even a national, scale” (Hechler-Faydherbe 2).⁶⁴

Thomas Dichter of the libertarian Cato Institute is one of the most outspoken microfinance skeptics.⁶⁵ Within the last several years, his published opinions have ignited a cacophonous debate among microfinance practitioners.⁶⁶

⁶⁴ She explained that microfinance improves lives on an individual scale through consumption smoothing and thwarting risk, and said that “a comprehensive history of analysis does not yet exist due to the nature of the industry and its clients” (Hechler-Faydherbe 2).

⁶⁵ Dichter is an author and seasoned development practitioner with considerable experience on the ground, including as a Peace Corp volunteer, country director in Yemen, and consultant with the Ford Foundation, the United Nations Development Programme (UNDP), USAID, the World Bank, and other organizations.

⁶⁶ A spokesman for Deutsche Bank claimed that one of Dichter’s articles “nearly caused a knife fight in our offices” (Margolis np).

As one of the few outspoken individuals warning against overconfidence and promises that may lead to disappointment, Dichter's words are useful to get an idea of where he and other skeptics are coming from:

Over-inflated expectations are unhelpful for several reasons. First, there is an opportunity cost involved when so much attention is paid to one sector—inevitably other possible answers to poverty reduction get less attention, especially if they seem more complex or difficult. Second, they propel more organizations to get involved in microfinance, some because that is where the limelight is shining. The proliferation of more and more players, while perhaps creating healthy competition, is also likely to add amateurishness where we need more professionalism, to add noise to a field that right now may need a bit of quiet time, and to raise the possibility of distortions in the microfinance marketplace as players vie for the same markets or client territory. Finally, over-inflated expectations make it more likely that in the excitement to do more of what appears to be such a good thing, more money will be attracted to microfinance. Hence the chances of some harm being done—collateral damage, if you like—become greater, if only because there are absorptive capacity limits on both the part of lenders and borrowers (despite a statistical basis for concluding that there exists huge unmet 'demand,' it remains to be seen whether or not that demand is 'effective demand'). (Dichter, Introduction 2)

The "self-satisfaction" he has described has certainly not arisen without cause, but results from highly-publicized anecdotal evidence and a multitude of academic analyses like those aforementioned. While a body of research has identified many of the benefits microfinance promises, independent and objective evaluations of development programs are always difficult to carry out, and the new fad of "impact evaluations" exacerbates the problem. This method of evaluation, now used by the World Bank, simply compares the impact of a

microfinance program with the hypothetical absence of a program (Ellerman 158-159). Clearly, this type of analysis will most often lead to positive conclusions

Additionally, a small but growing collection of literature marked by skepticism has emerged, some of which revisits a few of the most widely publicized studies of the past, casting doubt on their academic validity. For example, David Roodman and Morduch published a paper in June 2009 that analyzed some of the most celebrated studies on the impact of microcredit in Bangladesh. Based on their own interpretation of the data, they found that the published benefits were overstated (Morduch and Roodman, *The Impact of Microcredit on the Poor in Bangladesh*).⁶⁷

In a seminal study by Abhijit Banerjee, Esther Duflo, Rachel Glennerster, and Cynthia Kinnan, undertaken in conjunction with the MIT Department of Economics, the authors carried out what was the first randomized evaluation of the impact of introducing microcredit in a new market. They looked

⁶⁷ Two of the studies they looked at were published by World Bank economist Khandker and one was written by Khandker and Mark Pitt. Morduch and Roodman noted that Pitt and Khandker “apply a quasi-experimental design to 1991-92 data,” which concluded that microcredit raises household consumption, especially when provided for women. In another 2005 paper, Khandker concluded that microcredit helps the extremely poor even more than the moderately poor (though a significant body of research concludes the opposite). Morduch and Roodman analyzed the data and used more simple estimators; they found no impact on the level of consumption in the 1991-92 data and questioned the assumptions made by Pitt and Khandker. Morduch and Roodman did find evidence that microcredit reduced consumption volatility, however, the authors noted that the (seemingly obvious) association between microcredit and household spending may simply indicate that richer families borrow more, not that borrowing leads to improved income (Morduch and Roodman). In an earlier, similarly-themed 1999 paper, Morduch wrote that “The most important potential impacts are...associated with the reduction of vulnerability, not of poverty *per se*” (Morduch, *Does Microfinance Really Help the Poor?* np). Pitt published an extensive response disputing these assertions (Pitt).

at half of the 104 slums in Hyderabad, India⁶⁸ to see the effects of microfinance using the group lending model, focusing on areas where microfinance was introduced, and 15-18 months later making comparisons with areas without a significant microfinance presence. They surveyed a total of 6,850 households and looked at claims that microfinance does things like improve consumption, foster new business creation and enhance business income, and improve measures such as education, health, and women's empowerment.

The authors concluded their report by saying that, "While microcredit "succeeds" in affecting household expenditure and creating and expanding businesses, it appears to have no discernible effect on education, health, or women's empowerment [though they noted that after a while the impact of microcredit may translate into higher expenditures, improving these indicators]... Microcredit therefore may not be the "miracle" that is sometimes claimed on its behalf, but it does allow households to borrow, invest, and create and expand businesses" (Banerjee, Duflo and Glennerster 21).⁶⁹

⁶⁸ Hyderabad is the fifth largest city in India and the capital of Andhra Pradesh, the Indian state where microcredit has expanded the fastest (Banerjee, Duflo and Glennerster 3).

⁶⁹ They found that microcredit had important effects on business outcomes and the composition of household expenditure, noting that existing entrepreneurs used their loans to expand their business, and business profits increased. For household that did not already have a business when the program began, they did not increase durables spending, but increased nondurable consumption, such as food (meaning they probably used microcredit to pay down more expensive debt or borrow against future income). Meanwhile, households likely to start a business reduced nondurable spending and cut back on goods such as alcohol, tobacco, or lottery tickets. They noted that "the segment of the population that increased its consumption when it got the loan without starting a business may eventually become poorer because it is borrowing against its future, though it is possible that they are just enjoying the "income effect" of having paid down their debt to the money-lender (in which case they would be richer and perhaps continue to be richer in the future)" (Banerjee, Duflo and Glennerster 21).

Limitations

While it has certainly been shown that there are an abundance of cases in which microfinance has had a positive impact on the lives of the poor, and most published findings are impressive, it is important to take into account the numerous failures of past development initiatives, especially those that were based on successful experiences and academic support, then replicated identically elsewhere, unsuccessfully. It seems that based on the positive early findings found to be associated with microfinance in Bangladesh, the strategy was replicated elsewhere almost wholesale, even though the reasons for poverty can be unique in various locations. Past mistakes of overconfidence need to be avoided, which means retaining a sense of skepticism about the possibilities for microfinance.

Amidst Yunus' Nobel Prize, his best-selling book, and all the other sensation surrounding microfinance, it can be difficult not to get caught up in the celebratory ambiance and to overestimate the promise of microfinance.⁷⁰ It is important to understand that this strategy is not "the cure" for poverty,⁷¹ and in

⁷⁰ An overly sentimental video available on Youtube, by The Green Children, praises microfinance in Bangladesh, with lyrics such as "she's got a chance to make it on her own," "the power of choice," and "she finally broke the spell [of poverty]" (The Green Children, Hear Me Now).

⁷¹ For example, a FINCA campaign propelled by the star power of Natalie Portman, promoted on PBS, "The View," and MySpace, suggests that, by loaning money to entrepreneurs in the developing world, just a click of the mouse can end poverty. Using the FINCA "Village Bank Donation Calculator," a \$50 loan is said to "improve" 15 lives in one year, 45 in three years, and 75 in five years (FINCA Village Bank Donation Calculator). In an interview available on the MySpace campaign page, Portman stated, "I have seen that ending poverty is possible-it is just a mouse click away" (FINCA The Village Banking Campaign).

many places may not be the most effective strategy to combat it. Rather, it is a small but important piece of the development puzzle.

The microfinance success stories promoted to the public, recounting tales of poor women living in abject poverty that are able to grow their business and eventually do things like add rooms to their houses, send their children to school for the first time, and employ multiple workers, are by far the exception. Ricardo Bebczuk warned that, “Despite the impressive progress of microfinance in recent years, stakeholders should avoid over-optimism, rooted in an apparent over-advertisement of a few successful cases” (Bebczuk 1). While recipients of microcredit can sometimes achieve quick gains, most microentrepreneurs, especially own-account workers, continue to scrape by, plagued by the lack of basic changes that are needed for broader business development and economic and social progress, in areas such as education, health, infrastructure, the regulatory environment, and the elimination of corruption.

Lamentably, microfinance has not shown itself to be an effective tool for economic development as promised. Perhaps the most vociferous critic of microfinance is Milford Bateman. Bateman has argued that microfinance does not empower anyone, men or women. Rather, he believes it disempowers them by leaving them vulnerable to market forces. He has convincingly argued that microfinance supports the ideological underpinnings of neoliberal design, stating that microfinance serves to “discredit state and collective intervention strategies

and to increasingly recast community development and survival solely in terms of individual entrepreneurship” (Bateman, De-industrialization and social disintegration in Bosnia 207). In a damning article co-authored with Ha-Joon Chang, he wrote that “the current driver to establish the central role of microfinance in the development policy cannot be divorced from its supreme serviceability to the neoliberal/globalisation agenda” (Bateman and Chang 1).

Neoliberalism and the unfettered form of capitalism in which everything is left to the free market has already proven it is not a proper solution to poverty or underdevelopment, manifested in the failure of the Washington Consensus and resulting economic meltdowns in Asia and Latin America, in addition to the lack of regulation that precipitated the global economic crisis that began in 2008. Development policy should not, once again, rely too much on a framework that utilizes the market to dictate the best solution.

Microcredit use

A very important issue that should be raised is the paucity of empirical evidence as to how microcredit is actually spent. Researchers have acknowledged that it is extremely difficult to track the flow of money, and simply asking someone where their money was spent usually does not provide an accurate account. Data attained in the field, in which researchers observe firsthand how

microcredit is spent, is almost nonexistent.⁷² Formal financial institutions typically like to know where their loan money will be spent, and usually require it to go towards a specific purpose. It isn't unreasonable for MFIs to do the same.⁷³

It is well known that microfinance leads to “consumption smoothing,” in which the borrower is able to (sometimes surreptitiously) use their loan to pay for things such as emergencies, health care, clothing, or occasional “luxury items” such as radios or TVs. Consumption smoothing is generally regarded as being a very positive benefit associated with microfinance, especially for the self-employed whose incomes fluctuate throughout the year. A growing body of evidence suggests that perhaps most microcredit is actually spent on consumption smoothing, not business expenses.

In Paraguay, for example, street vendors report that earnings drop, sometimes significantly, during the hot summer months. Loans offered by MFIs can serve to bridge these expected and sometimes unexpected fluctuations in earnings, meaning microentrepreneurs are still able to provide for their families during rough times. Consumption smoothing demonstrates that many

⁷² The 2009 book *Portfolios of the Poor*, by Morduch, Stuart Rutherford, and Orlanda Ruthven, is the first study of its kind, in which researchers followed 250 poor individuals for a year in order to document their handling of finances. In a chapter that documented Grameen clients, they reported that the loans were used for productive purposes, and more than half of the clients reported that they used loans for daily needs like food, medicine, education, and paying off more expensive loans (Morduch, *Debunking the microfinance bubble*).

⁷³ In Bangladesh, CARE discussions with a wide spectrum of clients suggested that not more than 50 percent of microloans were being productively used in an activity that would produce earnings (Rahman 193).

microfinance clients do not take out loans to expand their business; they take out loans because their business does not provide them with sufficient income to cover their basic necessities, or indulge occasionally in “luxury items.” For these individuals, savings would be the preferable service to offer.

The growing realization that a significant portion of microcredit, if not most, goes almost entirely towards consumption smoothing and not business enhancement, is in line with what was witnessed in Paraguay. Loan officials for FP interview clients and ask for a basic explanation of how the loan will be spent, but do not follow up on the use of the credit.⁷⁴ While some purchase receipts are kept in client files, this documentation is sporadic. One client in San Lorenzo stated that she would use her \$1,100 loan to purchase inventory for her small store. However, taking a look around her store, it was evident that this loan amount was far larger than she needed to replenish her inventory, even several times over. The goods sold in her microenterprise consisted entirely of simple products of low quality, such as plastic cups, pens and pencils, paper plates, and napkins. And her purported goal was not to expand the products offered, but replenish this inventory.

Upon relaying this observation to the credit official, the business-related intention of the loan to purchase inventory was repeated, the manager signed off on the loan, and the money was issued later that week. While it is difficult to

⁷⁴ While the CME and rural lending programs provide credit to launch new business ventures, individual lending requires a business to already have been established.

imagine how this sum could be spent on low-cost products, the “success” of each branch was based on the amount lent (in addition to repayment rates), and credit officials are remunerated by a commission structure that rewards by loan size and quantity of loans dispersed.⁷⁵

Without doubt, microfinance has encouraged the poor in the developing world to borrow.⁷⁶ In parts of some developing countries, the roads are peppered with billboards advertising the services of MFIs, and MFI advertisements pilfer the radio waves, encouraging people to take their lives into their own hands by becoming entrepreneurs, or buying that television they have always wanted. What is most troublesome about this is that both types of borrowing are often equated with microfinance as a poverty fighting tool, which consumer credit is not. While consumer loans are certainly in demand, consumer-based microfinance is a far cry from the idea of microfinance trumpeted by Yunus and others, and will have little or no discernible effect on decreasing poverty.⁷⁷

⁷⁵ FP implemented a new commission structure in July 2008 that was meant to transform the incentives of credit officials so that the poor would be better targeted. The new commission structure induced great concern in the San Lorenzo office, and led several credit officials to seek employment at competing commercial MFIs that reportedly offered greater earning opportunities.

⁷⁶ There have been increasing reports of clients using a loan from one microcredit program to pay back a loan from another program, or even worse, seeking funds from a moneylender to repay a microloan in order to ensure a steady stream of microcredit. In some countries, “double-dipping,” wherein a microloan recipient receives a loan from multiple MFIs, can be upwards of 50 percent of clients or more. There have even been instances of borrowers taking out microloans to lend to others at higher rates of interest (Rahman 199-200).

⁷⁷ As of early 2010 there were no widely published studies on the possibility of consumer microloans actually increasing any indicators of poverty.

What about savings?

In the rush to provide credit to the poor and increase the number of clients served, it seems that savings for the poor have often been neglected. In reality, savings are the financial service most demanded by the poor, which is clearly indicated by the strong evidence showing that consumption smoothing is the most useful financial benefit tied to microfinance. Most banking services aimed at individuals find that demand for savings accounts is much greater than for loan accounts. However, in the microfinance industry, counter intuitively, in order to borrow, one must also save. Most MFIs focus only on disbursing loans, while services for savings are designed not to meet the poor's need for savings, but to provide collateral for loans and supply low cost capital (Hulme 20).⁷⁸

Littlefield remarked, "There is lots of evidence suggesting that poor people would rather save, turning small amounts into a lump sum, rather than borrow a lump sum and then pay it back, but the only way you can offer a safe place to save money is if you have sound, government-licensed, well-governed institutions. And that is what commercialization really means" (Hartford np). Some non-profit MFIs require borrowers to save, but mechanisms are often informal because they cannot legally allowed take deposits. FP requires that CME members establish a collective savings account, but this must be done with

⁷⁸ In some poverty-stricken parts of the world, the poor actually *pay* people to look after their deposits. In West Africa, for example, some people pay *susu* collectors a fee equaling a 40 percent annual interest rate simply for looking after their deposits (The Economist, Smooth Operators np). A study carried out in Uganda revealed that people with access to formal savings in banks saved three times as much as those without such access. (Helms 25)

an outside institution because the FP structure does not allow them to offer this service. The commercial competitors that offer savings accounts for individuals require a minimum of several hundred dollars or more to open an account, which is out of reach for most of the poor.

As Littlefield has explained, the push for commercialization is initiating changes in banking regulations that allow MFIs to collect savings. Unfortunately, in most countries NGO MFIs are still not allowed to accept deposits. Under the right circumstances, collecting savings from the poor could enable societies to make a collective leap forward; almost every country in modern history that has achieved progress on a significant scale has done so by utilizing savings, not by borrowing (Dichter, The chicken and egg dilemma et al.).⁷⁹

Commercialized microfinance

Microfinance is currently in the process of going through some profound changes. What initially began as a grassroots development tool is becoming a commercial operation; this has become the most heated and continuous debate related to microfinance. The reality that microfinance operations are “trickling

⁷⁹ Bateman and Chang have pointed out that, compared to its neighboring South and East Asian countries, Bangladesh has been one of the least successful at reducing poverty and encouraging “bottom up” productive enterprise development. They argue that, while the successful countries recycled domestic savings into larger, more sophisticated, technology-intensive, innovation-driven, and therefore growth-oriented enterprises, Bangladesh invested it (and international aid) into unsustainable informal sector microenterprises such as rickshaws, kiosks, traders, food stands, and street vendors. They attest that this perpetuates Bangladesh’s reliance on FDI and government spending on large investments (Bateman and Chang 12-13).

up” into the commercial sector produces numerous concerns and considerations that must be taken into account when moving forward.

The following section will discuss several of the themes most often discussed in regards to commercialization. These include interest rates and MFI profits (and the possibility of exploitation), the ability to collect savings, for-profit versus non-profit, and consumer loans versus small business loans. The way these issues are handled will be crucial for the progression of microfinance and its ability to continue to benefit the world’s poor.

Sometimes NGOs commercialize, or “scale up,” with the intention of improving sustainability and outreach and being able to offer services like savings, in addition to being able to make a profit. Most often, it is said to be done for a combination of these reasons. Additionally, commercial banks are quickly entering the microfinance market by “scaling down,” and many are making substantial profits while doing so.

People worry about the possibility that “mission drift” may be occurring, whereby the original poverty-related problems microfinance was developed to combat are set aside in the run for profit. Mission drift might entail MFIs charging “market” interest rates that will exploit the poor, because they have no other credit options, and/or that MFIs will no longer target their services towards

the poorest individuals, especially as the needs of investors become more important.⁸⁰

Others argue that commercialization is necessary for the industry to reach more people. According to this argument, MFI NGOs that are not financially self-sustaining are prone to waste money and importantly, may not be able to assist the poor at all if their donor funds dry up (though both commercial *and* philanthropic funds are affected by the health of the economy). Additionally, microfinance as practiced by NGOs may compete for funds with development projects in other areas. Aside from these concerns, it is certain that many MFIs are constrained by a lack of capital.⁸¹

Several studies have provided evidence for the case that MFIs do not do as much to target the poor when focusing on sustainability or profit. A body of existing literature demonstrates that most MFIs, especially the most financially efficient, tend to target the moderately poor and those who live in urban areas. Robert Cull, Asli Demirguo-Kunt, and Morduch analyzed data on 124 MFIs in 49 countries and found that there is a possibility of earning profits while serving the

⁸⁰ A 2005 survey by CGAP estimated that less than a quarter of the total MFI funding that has come from foreign institutions in recent years is most interested in earning a market rate of return (Callaghan, Gonzalez and Maurice 118). Littlefield pointed out that "with daily headlines trumpeting big investors seeking huge profits in microfinance, it is tempting to believe that this investment boom is about mainstream investors coming into the sector looking for purely financial returns. In fact, most investment in microfinance today involves a social motivation alongside a financial motivation. Since social mission is at the core of microfinance, there is a natural fit with socially motivated investors" (PR Newswire np).

⁸¹ Most respondents of a survey conducted by CGAP and MIX perceived funding to be the biggest constraint to growth. In some of the few situations where financing was not a restraint, growth rates of 50 percent to 100 percent were experienced (Meehan 1,5).

poor, but a trade-off emerges between profitability and serving the *poorest*. Their results were somewhat mixed, but they did conclude that as larger and older MFIs mature and grow, they focus increasingly on clients that can absorb larger loans. This seemingly demonstrates that these MFIs are not targeting the poorest of the poor, but the authors noted that it remains unclear whether or not their expansion had led them to target borrowers from a wider range of economic means, or whether return borrowers sought out larger loans as their businesses became profitable. Overall, they concluded that there *are* examples of MFIs that have managed to achieve profitability together with significant outreach to the poor, but they are the exceptions (Cull, Demirguo-Kunt and Morduch 31).⁸²

Between 2000 and 2006, Mersland and Strom studied MFIs of various structures, looking at NGOs and shareholder-owned firms (SHFs), including banks and non-bank financial institutions. While it is generally argued that NGO MFIs should commercialize in order to improve efficiency, which will ensure sustainability and improve outreach, the authors' findings indicated that the difference between shareholder owned MFIs and non-government MFIs is minimal, which contradicts established beliefs and policy guidelines in the industry (Mersland and Strom 598).

⁸² According to a World Bank publication, their experience with CGAP's Poverty Assessment Tool demonstrates the fact that those MFIs that *attempt* to reach very poor people tend to succeed (Helms 20).

They found that NGOs are not more socially oriented than SHFs, nor are SHFs more profit-oriented than NGOs. SHF's superiority in scale and scope do not seem to be related to ownership type, but to the legal constraints which impede most NGOs from mobilizing savings (Mersland and Strom 599). Many microfinance policy reports highlight the strengths of SHFs and weaknesses of NGOs, in particular emphasizing that NGOs are less commercial and professional because they lack owners with financial incentive to monitor management. "The implicit message is that SHFs benefit from better governance, can access more funding and thus perform better than NGOs" (Mersland and Strom 600). An alternative hypothesis provided by the authors is that SHFs and NGOs do not perform differently because they may use the same business model to compete and serve customers in the market.

Mersland and Strom pointed out that different ownership forms are actually common in the banking and insurance industries, and in mature bank-markets where different ownership types co-exist, researchers find little evidence to suggest that ownership type influences operational efficiency. The authors noted that agency theory⁸³ predicts that non-profit organizations can have an offsetting benefit of reducing customer adverse selection and moral hazard, since they may be closer to the customers and better able to tap into local information networks. For clients with low levels of education, this makes sense, as the

⁸³ Agency theory basically involves the costs of resolving conflicts between principals and agents and aligning the interests of the two groups.

relationships with depositors and borrowers are as important to the success of the bank as the manager's and the board's relationship with its owners (Mersland and Strom 600). The authors concluded that the theories do not bring clear predictions regarding the efficiency of different ownership types in microfinance markets. They believe the adaption of a legal framework that allows well-performing NGOs to mobilize saving appears to be a better option than transformation to a commercial structure.

Compartamos

The most notorious example used to rally against commercialization and to support claims of exploitation of the poor is that of Mexico's Compartamos. Compartamos began in 1990 as a non-profit MFI, and after experiencing growth, and in order to fulfill a desire to improve outreach, in 2000 the organization converted into a commercial-structured, for-profit MFI. The original shareholders of ACCION,⁸⁴ the International Finance Corporation (IFC),⁸⁵ and private Mexican investors initially invested \$6 million in the MFI (Acción 3).

Compartamos added more than 100,000 net new clients in both 2005 and 2006, totaling a compound annual growth rate of 46 percent in terms of clients and 60 percent in terms of portfolio between 2001 and 2006 (Acción 4). In 2006 Compartamos became a full-fledged commercial bank, and by April, 2007 had

⁸⁴ ACCION is partly funded by USAID.

⁸⁵ The IFC is the World Bank's private sector lending operation.

become the first Latin American MFI to carry out an initial public offering (IPO), selling 29.9 percent of its stock as a secondary offering on the Mexican Stock Exchange.⁸⁶ On just the first day of trading the price rose 32.3 percent, and after two weeks reached 49.8 percent above the initial offering price (Acción 9).⁸⁷ The early investment of \$6 million came to be worth about \$1.5 billion after this sale (Acción 1,8). Compartamos earned \$80 million in profit in 2007, and their portfolio grew to over \$400 million. Since going public, return on equity has been more than 40 percent (Malkin np).

A 2007 study by CGAP estimated that 23.6 percent of Compartamos' interest income went to profit, while its return on average equity was more than triple the 15 percent average for Mexican commercial banks (Malkin np). CGAP estimated that the average return on assets for self-sufficient organizations is 5.5 percent, while for Compartamos, this number reached 19.6 percent in the fourth quarter of 2007 (Malkin np). According to Mix data, by the end of 2009 Compartamos had a gross loan portfolio of over \$577 million, with over 1.5 million active borrowers.

⁸⁶ A secondary offering is the sale of existing shares rather than issuing new shares, so no fresh capital was funneled into Compartamos as a result of the sale. Raising new equity was not a need in early 2007, as Compartamos had other means of financing growth (Acción 6).

⁸⁷ Just over half the investors were from the U.S., and Mexican investors made up only 5 percent (Acción 9). As of mid-October 2009, the stock had declined about 30 percent since the IPO, but was still performing exceptionally well in comparison to other banks.

FINANCIAL PERFORMANCE 2002-2004

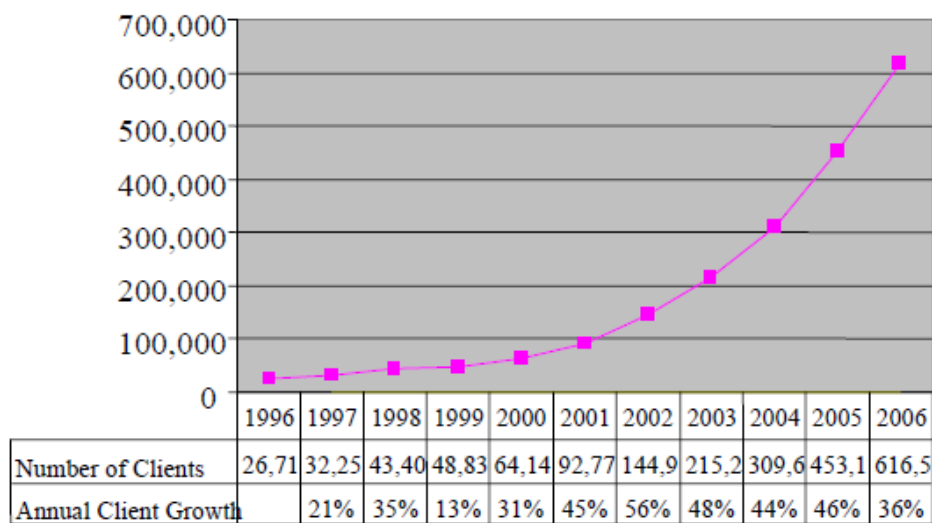
MICROFINANCE INSTITUTIONS-LAT.AM.	ROE
Compartamos - Mexico	52.2%
Credife (Bco.Pichincha) - Ecuador	50.9%
Confia Banco ProCredit - Nicaragua	39.3%
Banco del Trabajo - Peru	33.8%
Findesa - Nicaragua	32.0%
Fundacion WWB - Cali	31.5%
Bangente - Venezuela	29.0%
CONVENTIONAL BANKS- LATIN AM.	11.2%

Source: Marulanda & Otero, *Profile of Microfinance in Latin America*, Worldscope

Michael Chu, Harvard Business School

(Chu 2)

Figure 1: Number of Clients at Compartamos



Source: Microfinance Information eXchange.

(Acción 4)

Although financial outreach to the poor in Mexico undoubtedly increased, contention continues to accompany the enormous profits Compartamos earns. Most of the criticism comes from the fact that interest rates have remained high, averaging almost 90 percent annually (including 15 percent in government tax), even though costs fell and efficiency improved (Malkin np). Critics argue that the bank has essentially carried on the usurious interest rates of the moneylenders that microfinance was originally intended to replace. In much of the world, microfinance interest rates range from 25 to 45 percent. In Mexico, rates are said to be higher due to reasons such as inefficiency and limited competition.

Numerous detractors, including Yunus, consider profits earned by MFIs such as Compartamos to be exploitative. While Yunus acknowledged that “The need to constantly raise funds from donors uses up the time and energy of nonprofit leaders, when they should be planning the growth and expansion of their programs” (Yunus, *Creating a World Without Poverty* 10-11), he is wholly against profiting from the commercialization of microfinance. In a 2007 interview with PBS he remarked that, “just because they are willing to pay, I don’t think that’s a justification, if you call it microcredit, because microcredit has a philosophy. Microcredit has a purpose...to help people get out of poverty...Some people are saying that Compartamos is the future. I always say that Compartamos is the past...I hope that this will disappear very soon”(PBS Now). He has also been quoted as saying, in regards to Compartamos, “I don’t

want to associate with you, I want to battle with you and to fight you” (Hartford np).⁸⁸

Meanwhile, members of Compartamos and other supporters claim that the intention has been to improve outreach to the poor, which has been accomplished; they see nothing wrong with making a profit while doing so. Alvaro Rodriguez⁸⁹ claimed a desire to “...show the world that investing in the poor was a profitable venture, and that with a successful IPO we would attract funding from commercial sources to help the fight against poverty” (Acción 6). Furthermore, interest rates charged by Compartamos are in line with the rates charged by several of their competitors, and the number of small loans (under \$1,000) they provided is far greater than other commercialized banks in Latin America (Berger, Goldmark and Miller-Sanabria 55). Despite the controversy surrounding Compartamos, they are supplying a demand that exists, and customers have shown they are willing to pay the high interest rates that accompany the microcredit.

Organizations such as Compartamos, which focus on consumer loans, must be differentiated from traditional MFIs, which typically offer microcredit to fund microenterprise. Though various services may fall under the guise of “microfinance,” the services offered by Compartamos are quite different than

⁸⁸ Morduch commented that, “Yunus is concerned that his legacy, even the language of microcredit, is being appropriated. But the rest of the world doesn’t care and shouldn’t care” (Hartford np)

⁸⁹ Rodriguez sits on the board of several esteemed organizations, including ACCION, Compartamos, Harvard’s David Rockefeller Center for Latin American Studies, and others.

those offered by MFIs such as FP. Compartamos does not have an explicit goal of generating employment, or supporting microenterprise, but instead strives to offer various financial services for the poor, including consumer loans. Furthermore, their innovative techniques, which have been replicated by other MFIs, would likely not have been possible under a non-commercial structure.⁹⁰

An example that may be used to counter criticism levied at commercialization is BancoSol of Bolivia, which grew out of PRODEM, a non-profit organization. In 1992, with the help of ACCION, BancoSol became the first commercial bank in the world dedicated specifically to microfinance, and eventually became one of Bolivia's most successful banking institutions. In 1997 it became the world's first MFI to issue dividends to shareholders (Helms 52).

Initially, the organization's NGO status had limited its growth due to an inability to attract capital and collect savings. Facing these limitations, and given their belief that dependency on donors hampered development, a formal bank was created (Drake and Otero).⁹¹ At first BancoSol charged a combination of interest rates and fees equivalent to a 65 percent annual percentage rate. Today, with the influx of competition and a relatively commercialized environment, BancoSol's

⁹⁰ In October of 2009, for example, Compartamos applied for a unique license that will allow small local stores in rural villages to accept deposits and make loans to the bank's customers (Schmall np).

⁹¹ Early investment in the bank came from Bolivian individuals (\$52,500), Bolivian businesses (\$1 million), the Calmeadow Foundation (\$406,000), ACCION International (\$250,000), ECOS Holding (FUNDES group) (\$250,000), and PRODEM (\$1.4 million) (see Drake and Otero 1995) (Buechler et al. 93-94).

rates have dropped to around 22 percent (Helms 85), and loans are still being made predominantly to poor women in the informal sector (Bhatt and Tang 319).

While the idea of making profits off the poor is certainly disturbing, and by some accounts exploitation may be occurring, commercialization is the most effective way to improve financial access for the poor, and as the case of BancoSol demonstrates, does not necessarily entail excessive interest rates. While commercialization may raise as many questions as it answers, for the most part, the commercialization of microfinance is a positive trend, as financial access is an important component of development, and savings are especially important, and in most countries only available in a commercial or quasi-commercial setting.

However, detractors will persist, and for valid reasons, the criticism is warranted. Bateman has offered a trenchant analysis of development and the commercialization of microfinance: "...development policy cannot be undertaken as a commercial operation. Instead, development costs money to establish, it does not make money" (Hechler-Fayd'herbe 4).

Additional concerns

In some ways microfinance shares certain characteristics with predatory lending, such as poor analysis of a borrower's ability to repay; aggressive marketing of high-risk, high-interest loans; promotion of complicated loan

products not easily understood by borrowers; the collection of undisclosed charges and expensive fees, and payment of illegal kickbacks (Beirne 3).⁹² Complicated procedures, in addition to steep interest rates, are characteristics of microfinance.⁹³ For example, 58 percent of a random sample of Ugandan MFI borrowers said that they did not understand all the interest and fees they were expected to pay on their current loan, and 35 percent of these borrowers admitted that they withheld information about other debts from the lending agency (Wilksen Agencies).

S.S. Rahman explained that

Many NGO MFIs use the flat rate system, which is not easily understandable by the clients. A 15 percent flat rate interest is equivalent to about a 30 percent rate on a declining balance system used by banks. Not only the clients but even educated people sometimes have trouble understanding this system. The flat rate gives impression of a lower rate than it actually is, this is misleading and non-transparent. (Rahman 198)⁹⁴

⁹² Cecelia Bierne has drawn attention to several commonalities between the growing microfinance industry and the early stages of the subprime lending industry: “[1] Expansion of financial services to the underserved- in order to provide business opportunities to investors and access to funding for clients. [2] An influx of available funding to the markets- to enable rapid growth of business, in some cases from overanxious and inexperienced lenders. [3] The prevalence of high interest rates- in order to offset the increased risk in subprime markets and to cover operating expenses in microfinance markets. [4] Appearance of innovative new products- in order to facilitate market penetration, which is broadly adapted in spite of limited data on effectiveness. [5] Increased reliance on technology, to facilitate rapid growth, while distancing borrowers from lenders” (Beirne 3).

⁹³ At the Clinton Global Initiative in November, 2008, some of the world’s leading MFIs announced a collaborative effort to focus their industry on securing fair treatment for clients. This Campaign for Client Protection in Microfinance includes several core principles: ensuring that microfinance institutions do not engage in reckless or predatory lending; ensuring transparency with clients about prices, fees, and terms; treating clients with dignity, even during debt collection; keeping client data secure (Rhyne, Standards for Microfinance Growth 11).

⁹⁴ Another problem is the fact that usually no loan prepayment is offered, so if a client takes out a loan and pays it in its entirety the next day, they still pay interest for the year.

A very serious concern that has arisen in multiple parts of the world is the increasingly aggressive loan collection methods used by some credit officials. This topic, which is directly related to commercialization and rapid, unrestrained growth, has begun to receive considerable attention as of late 2010 due to an ongoing situation in India (where some MFIs have grown over several hundred percent in just the last few years). With enormous growth in the region and unprecedented competition, loan officials, remunerated by commission, are competing against each other for a limited number of clients.

This has led to increasingly aggressive marketing techniques and a sharply rising number of reports of unscrupulous collection methods, including threats and even the illegal seizure of property.⁹⁵ In the southern state of Andhra Pradesh where this phenomenon has erupted into a full-fledged crisis, there have been numerous suicides linked to borrowers' inability to pay their microloans. Families of the deceased have reported that over-indebtedness and threats from credit officials were the cause. Local political leaders have responded by calling for individuals to cease repayment of their loans, and some villages have barred MFI employees from entering.

A similar outcry against over-indebtedness and aggressive lending practices occurred in Bolivia on July 2, 2001 when an organization of fruit vendors, cobblers, and farmers armed with dynamite took the country's

⁹⁵ There have been periodic reports of similar abuses occurring in other parts of the world, including multiple cases in Bangladesh (MicroCapital np).

Superintendency of Banks hostage, demanding forgiveness or reduction of the debt they had incurred through microlenders. Elisabeth Rhyne explained that this was a result of over-indebtedness caused by a convergence of MFIs and consumer lenders as a result of the growth of microfinance in the late 1990s, which occurred in the midst of the major recession. She noted that this represented the perilous line between commercially-motivated microfinance and benevolently-charged microfinance, which employed similar rhetoric and were not differentiated by the debtors (Rhyne, Crisis in Bolivian Microfinance 3).⁹⁶

Concerns at Fundación Paraguaya

Even at FP, a non-profit MFI, individual lending rates hover around the 40 percent range, fluctuating slightly in response to market forces. While profits are reinvested to target poorer clients through the CME program, rural lending, and social programs, this interest is above the market rate, and borrowers (and some employees) have a hard time understanding why interest rates are so high if profit is not the motive. Some competitors in the Paraguayan microfinance market,

⁹⁶ There has been a mounting concern about over-indebtedness in Bolivian microfinance. In a late 2008 issue, MIX's Microbanking Bulletin explained that the majority of the Bolivian population now has access to financial services, and that lending requirements are becoming increasingly flexible, while underwriting practices for loans are becoming alarmingly aggressive (Robledo 1). Catalina Robledo noted that the Bolivian microfinance sector is at risk for over-indebtedness, created by an overabundance of supply. She quipped that "the Bolivian microfinance sector's success is at the source of its biggest risks today" (Robledo 4). It is this rapid and often unscrutinized growth, occurring in Bolivia and throughout the world, that led Morduch to predict that "there will likely be a big microfinance failure some place, bigger than what we have seen to date" (The Economist, Froth at the bottom np).

namely credit unions, offer much lower interest rates on loans. Unfortunately, they often require savings of at least several hundred dollars to establish an account, and underwriting practices are more stringent, leaving the poor with few other borrowing options. The fact that MFIs such as FP step in to offer these services to those otherwise considered un-bankable is a positive thing, even if rates are high.

Another point of concern is that FP receives funding through Kiva, an innovative internet site that allows individuals to lend money to microentrepreneurs across the world with just the click of a mouse and a debit or credit card. With funding from Kiva (and other sources), it is difficult to explain 40 percent interest rates. Part of the way FP receives the funding is by designating specific borrowers as Kiva entrepreneurs. These individuals have their pictures taken and stories recounted on the Kiva website. This is usually done without detailed explanation to the entrepreneur of what Kiva is and how their photograph will be used. Additionally, Kiva advertises to donors the ability to choose a specific entrepreneur in whom to invest, while in reality the funds are provided to FP in a lump sum, not designated for specific entrepreneurs.

Admittedly, the Kiva project would not work if borrowers had to wait on individual foreign donors to deem their business venture creditworthy. However, the way Kiva presents the system is very misleading; it actually provides a figure

that is meant to show how much more money the entrepreneur needs donated to receive their loan (Kiva has been working on improving transparency).

Microenterprise efficiency in Paraguay

Upon speaking with FP's credit officials and clients, and spending time scouring the profiles FP keeps on its clients (*carpetas*), it became apparent early on that many, if not the majority of microentrepreneurs in Paraguay, are engaging in businesses practices that are costly and inefficient, usually because they have no other recourse. For example, many of FP's clients simply go to the local market, often *Mercado de Abasto* or *Mercado Cuatro*, to purchase inputs for their business, such as cooking ingredients or fabric, or inventory like clothing or soda and snacks. Many others may go to the local grocery store to purchase items, and then resell them on the streets or in their nearby kiosks for a small markup. Remarkably, these entrepreneurs sometimes make these trips to purchase inventory several times a week, often spending less than \$20 at a time.

This practice is extremely time consuming and inefficient. Especially troubling is the fact that for many vendors, the time spent on the street or in their store is directly proportional to their income. Microcredit is meant to provide them with the working capital to purchase larger quantities at a time, but that is not how it is usually spent. Even with the availability of credit, microentrepreneurs continue to be risk averse. The cost of innovation is simply

too high; if a new business model or product does not work out, the result could be that a family does not eat.

Microcredit may be reinforcing and perpetuating inefficient business models that only keep microenterprises on the margins of survival. The majority of FP's clients are reliant on their loans for replenishing inventory and purchasing inputs, while paying interest rates around 20 or 40 percent, depending on the program. Consistently relying on high-interest credit to operate a business is not efficient. Microcredit may get the business' wheels turning, but very rarely at a quick enough pace for the entrepreneur to substantially expand his or her business, move up the economic ladder, and contribute significantly to the local and national economy.

Many of these microentrepreneurs never reach the point where they are able to take advantage of economies of scale. While stories of growth are widely publicized, lacking in the anecdotal evidence is the entrepreneur who starts a small business, saves enough capital to expand to another location, and another, eventually coming to operate a chain of enterprises with multiple employees. Instead, there are a number of FP entrepreneurs that actually operate two or three small businesses, working grueling hours to provide for the families.

Even the credit officials working at FP acknowledge that most of their clients operate microenterprises to *sobrevivir*, or survive, and do not entertain serious hopes for the type of significant expansion and growth that is possible in

developed countries where more favorable conditions exist. While the organization's mission and objective are to combat poverty and support informal sector entrepreneurialism, at least a few of their employees maintain that profit is equally, if not more important. Their beliefs, though possibly erroneous, and probably related to the necessary focus on sustainability, are substantiated by the commission structure, which, as of the early part of the summer of 2008, was based mainly on the number and size of loans, in addition to repayment rates. Within the organization, there seems to be a disconnect between the main office, whose employees tout poverty-fighting ideals and the empowering philosophy behind microfinance, and many of the credit officials actually working on the ground, who are motivated by commission for bringing revenue to the organization (as previously noted, the commission structure has since changed, and is structured to place more emphasis on impact).

Even if a microenterprise were to overcome the many obstacles characteristic of Paraguay's business environment, and grow substantially, in many cases it would be limited in its contribution to the local economy. Many of Paraguay's microentrepreneurs purchase imported goods, which they then resell in their respective kiosks. These goods are often purchased in, or originate from, *Ciudad del Este*, one of the world's largest smuggling points for goods. If the goods microentrepreneurs sell are simply smuggled from the more developed nations of Argentina and Brazil, then resold, without paying any type of taxes, this does little more than poverty alleviation on an individual scale, or simply

helps people trying to “*sobrevivir*.” While this improvement in opportunity in the lives of individuals is important, no macroeconomic progress is being made, nor is progress being made towards a sustainable solution to poverty.

A central element of microcredit that lends credence to those skeptical of microfinance’s ability to lead to sustainable and significant economic development, as highlighted by Timothy Nourse, stems from the fact that microcredit does not necessarily increase productivity. Instead, when not spent on the use of technology or capital inputs, microcredit serves to increase the use of available labor. This “means that informal businesses in microfinance programs initially experience high returns to their investments, but these returns then decrease and businesses continue to record low productivity levels” (Nourse 65). Nourse used the example of an MFI client that produces milk. This microentrepreneur would be more likely to invest in additional animals, which requires additional labor, rather than invest in milk-processing devices that may save time and increase labor productivity. These investments yield diminishing returns as labor productivity is maximized. “As a result, although microfinance has helped businesses to grow or expand, it has not increased their productivity or returns” (Nourse 65).

If countries want to really set themselves up for economic progress on a significant scale, and microfinance is to play a part, strategies that increase productivity and returns on labor need to be implemented. Most use of

microcredit, assuming it is spent on business purposes and not household consumption, is spent on inventory or other inputs that don't necessarily induce productivity gains. Furthermore, especially in Paraguay, microenterprise productivity is limited by deficient legal and regulatory regimes and lacking or non-existent infrastructure and public services. While microfinance may lead to improvements in individual lives, in the current environment, in Paraguay and in most countries, microfinance is not a viable method for considerable, sustainable economic growth.

CONCLUSION

In spite of the hope inspired by impressive success stories and quickly spreading popularity, microfinance is not the “elusive elixir” economists have been searching for. Microfinance has been a relatively effective strategy for assuaging the effects of macroeconomic crisis and globalization, particularly the resulting shortage of quality jobs and the increased need for microcredit. By itself, microfinance is not an effective tool to sustainably combat poverty on an aggregate, national scale, and will not increase macroeconomic growth. Providing liquidity to the poor does, however, provide some measure of relief from poverty for many of the world’s poor who lack access to financial services. Microfinance is especially effective when it is connected with social programs.

The microfinance movement currently stands at a crossroads. The results produced by microfinance and the way it should be implemented are increasingly coming into question. Within the next few years, a more definitive answer on microfinance and its actual potential for progress, in Paraguay and in the rest of the world, should become available. Although microfinance is one of the more successful tools devised for development to date, and the services provided by MFIs are in high demand, it cannot live up to its promise as advertised by its strongest proponents. The microfinance marvel has been exaggerated; the reality is that, in addition to concerns directly related to microfinance, there are simply too many other problems that must first be solved before microfinance can play a

part in banishing poverty to museums, as Yunus so often mentions.⁹⁷ Among many other reasons, microfinance will not lead to sustainable economic growth because there are so many obstacles to success faced by microenterprises in developing countries, and in reality microcredit is not consistently used for productive business purposes.

Microfinance is only a piece of the strategy for sustainable social and economic progress that can hope to wipe poverty from the globe. Microfinance has largely achieved its current level of importance due to the spillover effects of economic change and the transformation of the labor environment, which drew increased attention to the informal economy. While microfinance may fall short of its hype, and lingering concerns remain, it certainly can play an important part in abating poverty, and when combined with other measures, can be an effective tool to improve lives. However, the current focus on this particular strategy is overdone, as other initiatives that focus on the roots of poverty are at least as important.

A climate for microfinance

The past couple decades witnessed an enormous rise in the popularity of microfinance, with MFIs throughout the world spreading and growing at a

⁹⁷ Yunus has set a date of 2030 for the creation of a “poverty museum.” He believes that by then, not a single Bangladeshi will live in poverty (Tharoor et al.).

phenomenally rapid pace. In Latin America the popularity of microfinance spread especially quickly after the debt crisis and subsequent neoliberal reforms, which forced scores of individuals into unemployment and underemployment. When these displaced workers were unable to find decent work, many of them turned to the informal economy, often in the form of self-employment, which all but institutionalized informality. In Paraguay the causes were somewhat unique, but the effects were essentially the same.

While microfinance is a strategy that has been, for the most part, underutilized for many years, its importance and surging popularity is closely linked to steady or rising levels of informality in the economies of developing countries. Microfinance has been an especially important service for the self-employed who operate informally, many of whom fall into the category of own-account workers. While the flexibility offered by self-employment is beneficial for some, others are self-employed not because of their “entrepreneurial spirit,” or because it is financially lucrative, but because they have little other choice. This is especially true for those with little education and few skills suited for work in the modern economy.

For most, especially in countries with labor environments similar to Paraguay’s, microcredit is useful as a coping mechanism, but not necessarily a veritable way out of poverty. In large part due to the unavailability of social safety nets in developing countries, particularly for those employed informally,

microfinance has been demonstrated to be especially effective in its ability to reduce vulnerability. Many of the clients served by MFIs across the world, and especially in Paraguay, are own-account workers and do not belong to the “entrepreneurial class.” These vulnerable individuals work in highly competitive markets and are faced with unpredictable and often meager income. While for most in the developing world, turning to self-employment or own-account work is not a stepping stone into prosperity, it does allow the individual to provide for his or her family, which makes the services of MFIs important.

However, self-employment as encouraged by the microfinance movement possesses limited potential for the type of macroeconomic growth that can lift populations out of poverty. In spite of its explosive popularity, even some of the most ardent supporters of microfinance admit there is little potential for it to engender measurable economic improvement on a national scale. It may even be that in some cases, including Paraguay, MFIs actually reinforce the culture of informal self-employment, legitimizing a system in dire need of change.

Uncertain prospects

Microcredit for the poor, excluding consumer loans, has at times achieved demonstrable success in alleviating poverty. However, while financial services treat some of the symptoms of poverty, they are not a tool to eliminate the causes.

If poverty is to be eliminated, and if microfinance is to play a part, the many non-financial factors that contribute to poverty must first be addressed.

Socially motivated MFIs are making progress in tackling some of the problems associated with poverty, particularly in areas of health, education, and gender relations, but are only a small part of the solution. More so, the extent of these benefits is surrounded with uncertainty. While the potential benefits of microfinance have been widely advertised, up until recently, limitations and possible drawbacks have rarely been mentioned.

One of the most important facts about microfinance that needs to be acknowledged is that loans are often used for consumption smoothing, and not necessarily for productive business purposes. While this reduces immediate vulnerability, this was not the originally intended use for microcredit. This is a reality not usually discussed in the continuing push for microfinance.

Another point of contention surrounding microfinance is commercialization, which is a phenomenon that must be closely scrutinized in order to ensure that the best interests of the poor are met. Many commercial MFIs are earning extraordinary profits, by some accounts on the backs of poor customers with few sources for credit and little or no access to formal savings. These customers often pay interest rates comparable to those charged by the moneylenders microcredit is meant to replace.

More so, consumer loans are increasingly being offered to the poor, often under the guise of “microfinance,” which suggests that this is a service to fight poverty, while in reality it is not. Consumer lending by MFIs is especially prevalent in Latin America, and while it increases choice, it has little or no discernable effect on reducing poverty. While commercialization raises many questions, it does have its advantages, including increasing outreach, and, most importantly, allowing MFIs to offer savings accounts.⁹⁸

Areas of potential

Female empowerment

Probably the most important impact microfinance has produced in the developing world is a social, not an economic change. Socially-charged microfinance initiatives have shown a strong capability to improve gender relations and provide women with the tools to improve their own lives and the lives of their families. The empowerment of women that microfinance programs have produced will play a vital role in development efforts. Meaningful progress cannot occur when half the population is left out of the equation.

⁹⁸ At the same time, within a proper regulatory environment, a fully commercialized structure is not necessarily required to provide savings. Rather than singularly focusing on commercialization, there should be a greater push for flexibility in the type of institutions that can collect savings.

Savings and insurance

One of the greatest benefits of microfinance is its ability to reduce vulnerability. While this is done by offering credit, insurance and savings mechanisms are what the poor really need. It has been repeatedly demonstrated that the poor would rather save than borrow, which is evidenced by the fact that credit is so often used for consumption smoothing. Savings reduces vulnerability to unexpected expenses while avoiding the high interest rates associated with borrowing. Savings would be especially useful to the poor if anyone could use this service, not just borrowers.

Insurance services are also invaluable instruments to cushion the poor in times of hardship. These types of safety nets that are taken for granted in the developed world can play a crucial part in lifting the developing world's population out of poverty (i.e. access to credit, health and life insurance, unemployment insurance, pension plans and social security, workman's compensation, etc.). MFIs can be particularly suitable vessels to supply these services in developing countries, especially in the absence of a fully functioning government.

Rural poverty

Poverty is especially difficult to combat in rural areas. Many of the world's poor live a life of financial exclusion, but this is especially the case in rural areas. Mainly due to factors that limit efficiency, penetrating rural markets with microfinance has proven to be especially cumbersome, including for FP. Fighting rural poverty is an area in which microfinance possesses enormous potential. This is especially true because these individuals stand to benefit the most from the social programs offered by MFIs, as services in areas like health and education are often inaccessible in rural areas. A greater push for socially-charged microfinance in rural areas is important in Paraguay, and the rest of Latin America, where the poorest live. If MFIs are to play a part in meeting these needs, it will only be possible with government involvement and philanthropic funding.

Push for change

In its current state, microfinance may perpetuate informality and reinforce the underdevelopment related to it. By offering credit to meet the needs of the informally self-employed, MFIs may be inadvertently reinforcing low levels of microenterprise revenue, and perhaps even relieving some of the pressure on governments to introduce well-devised policies for the creation of jobs.

Instead of conveniently treating the symptoms of informal employment, namely limited access to credit and a lack of opportunity, MFIs should utilize their close ties with the entrepreneurial population to eliminate the causes. This means organizing the public to encourage governments to make the changes necessary to foster an environment for economic growth and productive employment. It has been demonstrated in several parts of the world that MFIs have the potential to spur government into action, most notably in Bolivia where the government enacted banking reforms amidst pressure from MFIs and their supporters.

In Paraguay, the prospects for entrepreneurial success are greatly impeded by the domestic business environment. Major improvements in legal and regulatory frameworks and public services are crucial for development efforts and for enhancing the efficacy of microfinance. If high poverty levels and the entrenched state of the informal economy are to be uprooted by meaningful employment and the services offered by MFIs, these changes are vital. This is especially true in Paraguay, where productivity is restricted by a combination of corruption, an inept legal and regulatory system, and nonexistent or deficient public services.

As De Soto has emphasized, sound regulatory and legal frameworks are essential components of successful economies. Much of the failure of neoliberal prescriptions is attributable to the fact that these mechanisms were not in place in

the underdeveloped world (Stiglitz, Globalization and its Discontents). These unresolved problems will continue to limit the development process by inhibiting the potential for microfinance.

Within a properly functioning regulatory and legal environment, in which paths to formal employment are less onerous, contracts are enforceable, and property rights are secure and transferable, the effectiveness of microfinance would skyrocket. If Paraguay were to make these improvements, the suppressed ingenuity and productivity of the informal sector would surface, leading to growth and a reduction in poverty. The first and most important step needed to realize this goal is to overcome corruption. Paraguay will never reach prosperity without surmounting this challenge.

Final thoughts on microfinance

Development efforts should not focus simply on increasing the size of economies. Development should strive to enhance the freedoms people enjoy, as Sen describes. By responsibly providing the poor with financial options, whether it is credit to fund a microenterprise or even a consumer loan for household items, this opportunity for the poor to utilize financial services, on a micro-level, is progress.

Unquestionably, organizations such as FP and Grameen are some of the most innovative and effective organizations of positive social and economic change ever created. However, there is much more than financial services that needs to be offered to the poor to provide them with the opportunity to improve their own lives. Microfinance must be carefully positioned within the puzzle for progress; the hype that microfinance has produced cannot be allowed to siphon funds and attention from other, perhaps more important development projects.

There is no particular microfinance platform that will work best in every region. Each area is unique, due to differences in things such as the labor environment, levels of education, and the overall national economic climate. Due to this fact, the effect microfinance may have on poverty will vary across different locations. In a country like Mexico, where educational attainment is relatively high and the economy is diverse, the types of services offered by commercial MFIs may be most in demand, particularly in urban areas. In rural or poorer areas, or in a country similar to Paraguay, the type of microfinance that is most effective can be much different. In Paraguay, opportunities for entrepreneurial growth are limited by the overall business climate. There, microfinance may be most useful as a coping mechanism, or for consumption smoothing, rather than in more developed areas where it may be used more for legitimate business needs.

Since so many microfinance clients in Paraguay operate on a very small scale and are unregulated and unprotected, initiatives that offer a safety net, such

as health insurance or pension plans, are especially needed. Educational initiatives, especially in basic financial literacy, can also be very effective when paired with a microloan. The group lending platform is important in Paraguay because it is able to reach those with lesser means, while offering lower interest rates and providing more of these social services than individual lending programs offer. On the other hand, individual lending is also needed for its flexibility in the size of loans, especially for enterprises that fall somewhere between “micro” and medium-size, but are still too small to be serviced by traditional banks.

There are few opportunities for the poor to utilize savings accounts in Paraguay, so commercial operations could be useful for this reason, in addition to increasing competition and lowering interest rates. However, the most effective way for MFIs to tackle poverty in Paraguay, as in other countries, is to create a regulatory environment that allows non-profit MFIs to collect savings. If MFIs such as FP were able to provide savings accounts, this would greatly increase their ability to help the poor. In addition, with a sound regulatory environment that increases the types of services non-profit MFIs may provide, many of the problems associated with commercialization can be avoided.

Microfinance is not going to be a panacea, but it does constitute an important ingredient in a recipe for progress. Microfinance can be effective and can play an integral role in leading people in Paraguay and other parts of the

world towards better lives. In order for it to do so most effectively, however, other pillars must be in place, including good governance, the availability of health care and education, sound infrastructure, and responsible environmental policy, all of which enhance the atmosphere for the creation of quality jobs. Only when these measures are in place will microfinance be able to reach its full potential. While this analysis has shown that microfinance cannot come close to bringing every one of the world's three billion disadvantaged people out of poverty, it can for some. And that is progress.

The market or the state?

Microfinance has impacted the lives and communities of over 150 million families across the world. However, there are still over three billion people in the world living on less than \$2 a day, more than a billion with no access to electricity and three billion without access to safe sanitation (Magner 8). Meanwhile, poverty is the world's leading cause of premature death. These are enormous problems to overcome. They can only hope to be solved with extensive intervention from both domestic and international actors, from both the private and public sectors.

The spreading appeal of microfinance was born in an environment where the role of the state was diminishing, as development prospects were recast into the hands of private organizations and reliance on the market. The ideology

behind microfinance is a direct response to the perceived failure of the state to effectively lead development and to improve the statistics mentioned above. Due to the comparative success microfinance has achieved in targeting poverty, it may serve to reinforce the trend of privatizing development. Currently, many initiatives undertaken to tackle penury, including primary health, education, and agricultural endeavors are moving out of the public and into the NGO and private sectors (Mosley 129).

As the poor take their fortunes into their own hands with microcredit, it may be that, to a certain extent, the available fallback of self-employment, supported by MFIs and backed with social services, absolves the government of some of its responsibility to intervene to improve the lives of the poor. This may be occurring in countries where government is moving away from its traditional redistributive role. By pursuing initiatives traditionally reserved for the state, some MFI programs may buttress this effect.

The role of Grameen in Bangladesh demonstrates this likelihood. Through several platforms, Grameen has assumed responsibilities the state has been unable to fulfill. Grameen now provides (sometimes obligatory) pension plans and life insurance, operates village phone programs, pursues energy initiatives using solar panels, and provides low cost health insurance to the poor, which is free for the indigent.

While these are worthy initiatives and are of great help to the poor, the fact that the state has been taken out of the development process is a concern, especially considering that the phenomenon is spreading. Development policy, once again following the trends of the time, should not entail a wholesale shift from state-led to privately-led efforts. State efforts should enhance the effectiveness of NGOs and aid organizations, and vice versa. A development approach that relies on the goodwill of private organizations, and/or the invisible hand of the market, is not going to be effective in the long term.

To achieve sustainable, replicable success, strategies such as microfinance must be positioned to combine market means with the efforts of private organizations, as part of a larger national strategy that entails significant, responsible state involvement. Though there will never be an elixir for poverty, any approach that hopes to come close will need a combination of “yesterday’s unexamined faith” *and* “the new superstition.”

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